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The Educational Benefit Trust:Loophole or Sinkhole?

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I. INTRODUCTION

An educational benefit trust is a recently devised plan for bestowing non-compensatory fringe benefits on key employees of corporations, with favorable federal income tax consequences to both the corporate employer and the employee. While the Internal Revenue Service vehemently attacked the educational benefit trust (EBT), proponents of these arrangements offer persuasive arguments supporting the validity of the favorable tax treatment claimed to result from their use. Although this beneficial result may not have been intended by Congress and the courts, a careful review of relevant statutory and case law leads to the conclusion that a properly designed educational benefit trust can offer a desirable method of compensating select employees.

II. Background

A. *Deferred Compensation Plans in General*

Deferred compensation plans are arrangements designed to maximize the after-tax level of compensation to an employee, while minimizing the cost of such compensation to the employer.[1] Deferral plans are intended to attain both tax and non-tax, or business, goals of the employer and the employee. In general, factors that should be taken into account in formulating a compensation program include cost and motivational effectiveness, accounting treatment, current trends toward salary compression, increased executive mobility, earlier retirement, inflation, and the cost of money.[2] Additional business considerations for the employer are increased loyalty and effectiveness of employees, retention of key employees, increased profits, attraction of new, quality employees when cash flow precludes high-level cash compensation, and enhanced corporate image regarding social responsibility. The tax goal of the employer is to obtain a deduction from gross income for the compensatory payment no later than it must report the item on its financial statements to shareholders and potential investors. The employee, on the other hand, seeks to exclude entirely the payment from his gross income or at least to defer taxation until a later date and at the most favorable rates.

Specific kinds and forms of deferred compensation arrangements are so numerous that an exhaustive listing is prohibited,[3] but a general outline of a typical plan suggests the flexibility and adaptability of these schemes. Generally the employer will agree to pay its employee a fixed sum, an amount based on the employee's number of years of service, or a stated percentage of the employee's career salary or peak salary upon retirement, termination, or after a specified time period. Payments to the employee may be in a lump sum or in installments over a number of years. Some plans provide for a fixed number of payments so that if the employee dies before all payments are made the remainder will be paid to a designated

1. *See generally* Kroll, T.M. 20-4th, *Deferred Compensation Arrangements* (1972).

2. Robins, *Employee Perquisites: What Kind, For Whom, How Much; Tax and Business Factors in Planning a Competitive Program of Compensation*, 32 N.Y.U. Inst. on Fed. Taxation 881, 883 (1974). *See also* Leo, *Selecting the Best Compensation Package*, Bus. Horizons Mar.-Apr. 1971, at 53.

3. A partial list of widely used methods of deferred compensation includes qualified pension, profit-sharing, and annuity plans, qualified and nonqualified stock options, stock purchase plans, restricted property arrangements, and nonqualified disability and death benefits plans.

beneficiary. Frequently the deferral agreement will contain forfeiture provisions designed to retain the employee, to increase loyalty to the employer, or to avoid inclusion of the compensation in the employee's current gross income.

Finally, deferred compensation arrangements may be classified as either qualified or nonqualified plans and as funded or unfunded plans. A "qualified" plan consists of a trust fund for the benefit of employees, established by the employer in accordance with the requirements of sections 401-407 of the Internal Revenue Code of 1954.[4] Section 404(a) allows the employer a deduction, limited in amount, in the year of the contribution to the fund; section 501(a) exempts from taxation the income produced by the trust; and section 402(a) permits the employee to defer inclusion of his interest in the fund in his gross income until the year in which such interest actually is distributed or made available to him.

To "qualify" for this tax treatment, the trust fund must satisfy the myriad of requirements imposed by section 401, the most burdensome of which, in many situations, prohibits the plan from discriminating in favor of officers, shareholders, or key executives.[5] Plans that fail to meet the requirements of section 401(a) are "nonqualified" plans. Section 401(b) provides that contributions to a nonqualified trust are includible in the employee's gross income in accordance with section 83, which requires inclusion in "the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or not subject to a substantial risk of forfeiture. . . ."[6] Furthermore, section 404(a)(5) prevents the employer from deducting the contribution to the trust until the "taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. . . ."[7] Finally, income produced by a nonquali-

4. Unless otherwise indicated, all references are to the Internal Revenue Code of 1954, as amended, and regulations promulgated thereunder. Basically, in order to "qualify" a plan must be a permanent, written program, established by the employer, funded, and nondiscriminatory.

5. INT. REV. CODE OF 1954, § 401(a)(4) provides:

> (a) Requirements for Qualification-A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section-. . . (4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

6. INT. REV. CODE OF 1954, § 83(a).

7. INT. REV. CODE OF 1954, § 404(a)(5).

fied trust fund is not exempted from taxation by section 501(a). The distinction between funded and unfunded plans is whether the employee's interest in the trust is represented by a mere promise by the employer to pay the benefits, or whether the interest is represented by notes or is secured in any way. If a nonqualified plan is not funded, a cash basis employee will not realize income as his employer's future liability accrues, regardless of whether the employee's rights are forfeitable.[8] If a nonqualified plan is funded, the employee's interest in the funding property may satisfy the "transferability" or "substantial risk of forfeiture" tests of section 83,[9] thus requiring the employee to include the interest in his gross income in the year of the contribution by the employer. Therefore deferral arrangements often should be designed as unfunded plans to avoid taxation of the contribution (under sections 402(b) and 83) prior to actual receipt by the employee of the compensation needed to pay the tax liability.

B. Basic Concept of Educational Benefit Trusts

Although the detailed provisions of various educational benefit trust plans may differ,[10] all EBTs share certain characteristics. The basic structure of any EBT is that the corporate[11] employer contributes funds pursuant to a written plan and trust agreement to provide educational scholarships or benefits for the children of selected employees.[12] The trust fund is managed by an independent trustee, and contributions by the corporation are irrevocably committed to the trust since they may never revert to the employer nor vest in the employee-parent. Children of employees covered by the plan are

8. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174; Rev. Rul. 70-435, 1970-2 CUM. BULL. 100; Rev. Rul. 71-419, 1971-2 CUM. BULL. 451.; Goldstein & Meilman, T.M. 34-3rd, *Life Insurance—Corporate Business* Use 10 (1975).

9. *See* note 6 *supra* and accompanying text.

10. For a discussion of various companies that design, promote, set-up, and administer EBTs, see Andrews, *Fringe Fracas: Companies' College Aid to Employees' Children Raises Hackles of IRS*, Wall Street J., Aug. 6, 1975, at 1, col. 6 [hereinafter cited as Andrews].

11. Individual partners cannot reap the income tax advantages of an EBT since each partner is taxed on his distributive share of partnership income regardless of whether such income is currently distributable. Treas. Reg. § 1.702-1 (1956).

12. Although an EBT could be designed to provide educational benefits for children of all employees, they usually are limited to children of key executives due to the high cost of establishing and administrating the trusts. Administrative fees charged by one company in the business of promoting EBTs equal 7.5% of disbursements; a second such company charges 1.5% of trust fund balances. Andrews, *supra* note 10, at 17, col. 5. To avoid application of the doctrine of "constructive dividend," participants should not be limited to shareholder-employees. *See* note 155-57 *infra* and accompanying text.

entitled to receive disbursements from the trustee only if and when they become a candidate for a college or postgraduate degree at an accredited college, university, or vocational school before reaching a certain age specified in the trust agreement, and only after actually incurring educational expenses.[13]

All EBT agreements impose provisions by which the interests of the selected employees' children, the beneficiaries of the trust, may be forfeited. Conditions of forfeiture may include voluntary termination of the employment relationship by the employee-parent, failure of the beneficiary to become a degree candidate before attaining the specified age, or failure of the beneficiary actually to incur educational expenses.[14] Conditions of forfeiture are included in the trust instrument by the employer to insure satisfaction of its business goals in establishing the EBT, such as continuity of employment and increased loyalty to the corporate employer, as well as achieving the tax goal of avoiding immediate recognition of the contribution as gross income to the participating children or their parents.[15] Should forfeiture occur, the unused funds are made available to the remaining beneficiaries on a pro rata basis or are transferred by gift to a tax exempt organization qualified under section 501(c)(3).[16] In no event do the forfeited funds revert to the employer or vest in the employee.

Funding of educational benefit trusts may assume either of two forms. Under one approach, the corporation makes annual contributions of an actuarially determined amount sufficient to satisfy a specified level of educational expenses for participating children who will be eligible to receive disbursements in the future.[17] Separate accounts are maintained for each potential beneficiary and income accumulated by the trust is distributed pro rata among the accounts. The second method of funding an EBT grants the employer's board of directors the discretion to determine the amount

13. Typically, EBT plans are written to recognize any accredited college, university, or vocational school and to honor bills for tuition, fees, room and board, supplies, and limited travel. Clothes, pocket money, and social expenses are excluded. Andrews, *supra* note 10, at 17, col. 4.

14. Henkel & Hackett, *An Analysis of Educational Benefit Trusts: How They Work, the Advantages, the Problems*, 42 J. TAXATION 346 (1975) [hereinafter cited as Henkel & Hackett]. Note that children participating in the EBT are not required to pursue a particular course of study or ever perform any services for or on behalf of the employer.

15. *See* note 6 *supra* and accompanying text.

16. Henkel & Hackett, *supra* note 14.

17. *See* Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 6; Henkel & Hackett, *supra* note 14; Teschner, *Basye Projected: Fringe Benefits and the Supreme Court*, 51 TAXES 324, 330 (1973) [hereinafter cited as Teschner].

of the corporate contributions to the fund. Separate accounts for each potentially eligible child are not established by the trustee; rather, he is given total discretion to pay any portion of a beneficiary's educational expenses limited only by the availability of trust funds and projected requirements of future recipients.[18] Regardless of which approach to funding is used, the level of contributions is determined with regard only to expected educational expenses. Contributions cannot be geared to the salary level of the parent-employee, nor can the employer discriminate on the basis of the status of the employee as a shareholder or nonshareholder. Similarly, no adjustment can be made to salaries of employees with no or few potentially eligible children, and employees can never receive anything in lieu of participation in the EBT.[19]

Whether educational benefit trusts can accomplish the basic business and tax goals sought by corporate employers and their employees is yet to be proven. EBTs should aid in retaining key employees and in increasing loyalty to the corporation of those employees covered by the plans, and thus employee efficiency and the accompanying effect on corporate profits may well result. The image of the corporation as a socially responsible entity should be enhanced. These gains may be offset somewhat by decreased morale among employees excluded by the plan and by shareholder skepticism of the necessity of yet another expensive benefit for top management. Regardless of the extent to which EBTs satisfy business goals of participants, the future of such plans depends on whether they can accomplish the intended federal income tax goals. Without the attendant tax benefits, EBTs generally are considered too expensive to be an attractive compensatory arrangement.[20] The tax benefit sought by corporations is an immediate deduction from its gross income for the contribution to the fund; the tax benefit sought by the participating employees is the tax-free receipt of the disbursements as a scholarship to the beneficiary-child under section 117, or at least, taxation to the recipient-child, who should be in a lower tax bracket than its parent, deferred until actual distribution of the funds at a substantially later date. If the corporation is denied

18. Henkel & Hackett, *supra* note 14.

19. *See* Teschner, *supra* note 17. The prohibition on adjustments to salaries of childless employees and the ban on gearing contributions to salary levels of employees are necessary to support the claim of proponents of EBTs that the disbursements are noncompensation fringe benefits, an argument vital to the success of the participants if challenged by the Internal Revenue Service. *See* note 64 *infra* and accompanying text.

20. *See* Andrews, *supra* note 10.

a deduction or is required to delay the deduction until actual receipt of benefits by participating children, or if the employee is required to include the contribution in his gross income in the year contributed by his employer, then the cost of EBTs in after-tax dollars would exceed that of other fringe benefits providing similar non-tax or business advantages to the employer.[21]

The reaction of the Internal Revenue Service to EBTs predictably has been hostile.[22] The Service has announced its intention to allow a deduction to the employer only in the year in which an amount attributable to the contribution is includible in the gross income of the employees participating in the plan, pursuant to section 404(a)(5). Furthermore, the Service will include the contributions to the trusts in the gross income of the parent-employee as compensation in the year in which the right to receive a distribution from the trust becomes vested in the beneficiary, pursuant to sections 402(b) and 83.[23] Clearly, if the Service's contentions regarding the appropriate tax treatment of an educational benefit trust are sustained by the courts, the desirability of using that fringe benefit arrangement will be reduced severely.

III. ANALYSIS OF EDUCATIONAL BENEFIT TRUSTS UNDER THE INTERNAL REVENUE CODE OF 1954

A. *The Internal Revenue Service's Position*

(1) Employer's Deduction for His Contribution

Advance Revenue Ruling 75-448,[24] announcing the Service's intended taxation of EBTs, treats such plans as nonqualified, unfunded deferred compensation arrangements. Although a corporate employer normally is allowed an immediate deduction for all "ordinary and necessary" expenses incurred in operating its trade or business, including a reasonable allowance for salaries or other compensation, such deduction will not be immediately available to the corporation under section 162[25] if the expenditure falls within

21. *Id.*

22. *See* Address by IRS Commissioner Donald C. Alexander, Houston Bar Association and Houston Chapter of Texas Society of Certified Public Accountants, Feb. 13, 1975, in BNA Daily Tax Report for Executives, p. G1, Feb. 14, 1975.

23. Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 7.

24. *Id.*

25. INT. REV. CODE OF 1954, § 162(a)(1) provides:

(a) In General - There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

the provisions of section 404(a), which adds additional conditions of deductibility to the "ordinary and necessary" test of section 162.[26] If the contribution is to a trust fund or other plan that does not satisfy the requirements of section 404(a)(1), (2) or (3) (relating to qualified pension trusts, employees' annuities, and stock bonus and profit-sharing trusts) and therefore is a "nonqualified" plan, the employer's deduction will be governed by section 404(a)(5), which allows a deduction only "in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan. . . ."[27] As applied to EBTs, the employer's contribution will be deductible in the year of actual receipt by the employee's child (since the beneficiary's interest in the trust is forfeitable before actual disbursements and, therefore, not includible in gross income until that event),[28] but only if the contribution also satisfies the "ordinary and necessary" test of section 162. Section 162 expressly covers expenditures for compensa-

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered; . . .

26. INT. REV. CODE OF 1954, § 404(a) states:

General Rule - If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, *or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation*, such contributions or compensation shall not be deductible under Section 162 (relating to trade or business expenses) or Section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either of such sections, they shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year. (emphasis added).

27. INT. REV. CODE OF 1954, § 404(a)(5). Treas. Reg. § 1.404(a)-12 (1966) clarifies this preemptive effect and states:

Section 404(a)(5) covers all cases for which deductions are allowed under section 404(a) but not allowable under Paragraph (1), (2), (3), (4) or (7) of such section. No deduction is allowable under section 404(a)(5) for any contrihution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under section 404(a). See § 1.404(a) -1 . . . .

In addition, § 83 of the Internal Revenue Code of 1954 (relating to property transferred in connection with the performance of services) may be applicable to the EBT contribution. Section 83(h) provides:

(h) Deduction by Employer - In the case of a transfer of property to which this section applies or a cancellation of a restriction described in Subsection (d), there shall be allowed as a deduction under Section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under Subsection (a), (h) or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

28. *See* note 35 *infra* and accompanying text.

tion,[29] limited solely by a reasonableness requirement. Advanced Revenue Ruling 75-448 holds that the contribution to the EBT is within the scope of section 404(a)(5) since such a trust is "a plan deferring the receipt of . . . compensation."[30] The employer may deduct the contribution in the year of disbursement to the recipients if such contributions are payments solely for services actually rendered and the amount of the employee's salary plus the deferred compensation[31] does not exceed a "reasonable allowance" for compensation for the year in which the services were rendered.[32]

(2) Employee's Tax Liability Upon Disbursement

Gross income is defined in section 61(a)[33] as "all income from whatever source derived, including (but not limited to). . . [c]ompensation for services, including fees, commissions, and similar items. . . ." If, as the Service maintains, an educational benefit trust forms part of a plan deferring the receipt of compensation, the taxability of amounts contributed to such a trust is prescribed by section 402(b), which requires contributions by an employer to a non-exempt employee's trust to be included in the employee's gross income in accordance with section 83.[34] Section 83 requires an employee to include in his gross income the value of property transferred by his employer to a third party as payment

29. *See* note 25 *supra*.

30. Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 7.

31. Treas. Reg. § 1.404(a) - 1(b) (1966) imposes the requirement of aggregating all compensation received for rendering services in a given year regardless of when such compensation is actually received in applying the "reasonable allowance" standard.

32. As will be discussed later, it is critical to examine the Commissioner's contention that a contribution to an EBT is "compensation" to the employee. In Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, the Service supports this position by stating "[t]he compensatory character of the contributions is established by the fact that the amounts are contributed on the basis of the parent's employment and earnings record, rather than on the basis of competitive criteria, such as need, merit or motivation." Under the facts given in the ruling, participation in the EBT is limited to children of employees who have completed at least twelve months of continuous service, are salaried over $15,000 per year, and whose customary employment is more than twenty hours per week and more than five months per year.

33. INT. REV. CODE OF 1954, § 61(a).

34. INT. REV. CODE OF 1954, § 402(b). Section 402(b), in part, provides:

> Contributions to an employee's trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under Section 501(a) shall be included in the gross income of the employee in accordance with Section 83 (relating to property transferred in connection with performance of services), except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property for purposes of applying such section. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him in the year in which so distributed or made available, under Section 72 (relating to annuities). . . .

for the employee's services in the first taxable year in which the third party's beneficial interest in the property becomes transferable or is not subject to a substantial risk of forfeiture.[35] Thus, while the question of *who* is taxable on disbursements from an educational benefit trust is governed by sections 61 and 83(a), the question of *when* such person is taxable is determined under sections 402(b) and 83(a). As discussed above,[36] if section 83(a) is applicable to EBTs, the proper person to include the disbursements in his gross income is the person who performed the services for which contributions to the EBT were made. The key to the latter question concerns when a forfeitable interest in an EBT "vests" in the beneficiary so that the rights of that person are "transferable," or are "not subject to a substantial risk of forfeiture." The regulations state that a beneficial interest is nonforfeitable within the meaning of sections 402(b) and 404(a)(5) if no contingency exists under the plan that may cause the employee to lose his rights in the contribution.[37] Additionally, proposed regulations make the definition of "vesting" turn on the definitions of "transferable" and "not subject to a substantial risk of forfeiture" found in section 83(c).[38] Section 83(c)(1) states that "[t]he rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual,"[39] and section 83(c)(2) provides that "[t]he rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture."[40]

In Advance Revenue Ruling 75-448, the Service applies the above rules regarding taxation of deferred compensation to a hypo-

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35. INT. REV. CODE OF 1954, § 83(a). Section 83(a) provides:

(a) General Rule - If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of -

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. . . .

36. *See* notes 33-35 *supra* and accompanying text.

37. Treas. Reg. § 1.402(b) - 1(a)(2)(i) (1966).

38. Proposed Treas. Reg. § 1.402(b) - 1(a)(2) (1971).

39. INT. REV. CODE OF 1954, § 83(c)(1). *See also* Proposed Treas. Reg. § 1.83-3(c) (1971).

40. INT. REV. CODE OF 1954, § 83(c)(2). *See also* Proposed Treas. Reg. § 1.83-3(d) (1971).

thetical EBT, and concludes that the employee-parent will be taxable when his child becomes entitled to receive disbursements from the trust by becoming a candidate for a degree at an educational institution and actually incurring educational expenses, so that there is no longer a "substantial risk of forfeiture" under the trust agreement. The employee is not required to include the contribution to the EBT in his gross income at the time it is made by the employer since the right to receive disbursements is conditioned upon the employee's continued performance of services for the employer. The Service, in the Advance Ruling, does not discuss the reason that the benefits received from the trust are includible in the gross income of the employee rather than that of his child; it simply paraphrases section 83 and declares by fiat that this treatment is appropriate.

B. *Taxpayers' Position*

(1) Deductibility of Contributions

Although the applicability of section 404(a)(5) determines the timing of the employer's deduction for contributions to an educational benefit trust, the "ordinary and necessary" test of section 162,[41] which covers all business expense deductions, determines whether the employer will be allowed any deduction for the contributions. In general, for an expenditure to be deductible under section 162, such expenditure must be ordinary, necessary, attributable to current operations, and proximately related to the corporation's business and its attempts to produce or collect income.[42] If contributions to EBTs are characterized as compensation, as contended by the Service, deductibility becomes largely a question of whether the payments are reasonable in amount and are in fact compensation purely for services.[43] But if such contributions are viewed as non-compensatory fringe benefits, the employer still will

41. *See* note 25 *supra*.

42. Teschner, *supra* note 17, at 341.

43. Treas. Reg. § 1.162-7(a) (1958). Factors to be considered in determining the reasonableness of a given level of compensation include compensation in prior years, compensation in comparative industries, dividend history of the corporation, number of work hours, experience, prestige value of the employee's name, special knowledge or qualification of the employee, complexity of the business, the manner in which the level of compensation was fixed, whether the level of compensation is geared to stockholdings, how the employer treats the amount on its books, economic conditions, volume of business, the employee's contribution to the success of the employer's business, and the level of compensation of other employees of the employer. Holden & Suwalsky, T.M. 202-3rd, *Reasonable Compensation* (1974); Woyke, T.M. 211-2nd, *Qualified Plans - Deductions* A-3 (1972).

be entitled to a deduction under section 162 if the contributions satisfy the "ordinary and necessary" test of that section. The term "ordinary" has been interpreted by the courts to mean only that the expenditure be normal in the circumstances or common in the type of business in which the taxpayer is engaged,[44] not that "the payment must be habitual or that the same taxpayer will have to make them often."[45] Similarly, the term "necessary" has been held to mean "appropriate and helpful in promoting, protecting and maintaining" the business of the taxpayer, not "mandatory" in the sense of a legal obligation to pay.[46] Although these terms have been defined, discussed, and applied in numerous judicial decisions, whether or not a particular expenditure is "ordinary and necessary" remains a question of fact to be decided from the circumstances of each case.[47]

In granting non-compensatory fringe benefits to employees, the employer is motivated by a desire to enhance the loyalty and esprit de corps of its employees and the general goodwill and image of the company within the community. The courts have recognized these goals as appropriate bases for expenditures by employers and have allowed deductions under section 162 for expenditures made in pursuit of such objectives.[48] In upholding a corporate taxpayer's business expense deduction for amounts contributed to an employee's savings trust, the court in *Mississippi River Fuel Corp. v. United*

44. Deputy v. DuPont, 308 U.S. 488 (1939); Welch v. Helvering, 290 U.S. 111 (1935); United Draperies, Inc., 41 T.C. 457 (1964).

45. Welch v. Helvering, 290 U.S. 111, 113-14 (1935) (Cardozo, J.).

46. United States Equip. Co., 22 CCH Tax Ct. Mem. 1309 (1963); *accord*, Blackmer v. Commissioner, 70 F.2d 255 (2d Cir. 1934). *See also* General Bankshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964).

47. *See, e.g.*, Welch v. Helvering, 290 U.S. 111 (1935).

48. Weil Clothing Co., 13 T.C. 873 (1949) (contribution to employees' aid association existing for purpose of providing education, recreation, and amusement to members, paying sick and disability benefits to members, and providing group life, accident, and hospitalization insurance); W.M. Ritter Lumber Co., 30 B.T.A. 231 (1934) (contribution to employees' committee for welfare work among employees); Missouri Pac. R.R., 22 B.T.A. 267 (1931) (contribution to local hospital serving employees); Lemuel Scarbrough, 17 B.T.A. 317 (1929) (payment to sick benefit fund for employees); Sugarland Industries, 15 B.T.A. 1265 (1929) (contribution to association for erection and equipment of hospital for employees); Holt - Granite Mills Co., 1 B.T.A. 1246 (1925) (contribution to grade school near employer's factory where majority of students were children of employees). *See also* Rev. Rul. 74-51, 1974-1 CUM. BULL. 45 (contribution under union agreement to trust fund to be operated for the benefit of educational, cultural, and charitable uses deductible under Section 162); Rev. Rul. 69-478, 1969-1 CUM. BULL. 29 (contribution to employees' trust to provide group health and life insurance for active and retired employees); Rev. Rul. 67-315, 1967-2 CUM. BULL. 85 (direct payment to active and retired employees for reimbursement of Medicare premiums).

States[49] alluded to the unfairness of denying any deduction to an employer for expenditures designed to promote employee loyalty and efficiency, and noted that this method of cultivating goodwill frequently is used by many successful business concerns. The court stated that deductions for expenditures actually made for business purposes should not be denied unless the language of the statute compelled the denial. Furthermore, if the business purpose of a contribution to an employee trust fund by an employer is to maintain the loyalty, morale, and goodwill of its employees, it is immaterial that the use made of such funds by the trust would not be deductible if made directly by the employer.[50] In *Forbes Lithograph Manufacturing Co. v. White*,[51] the court upheld a deduction for the employer's contributions to a foundation that used the funds to benefit employees and their dependents in cases of illness and emergency. The court stated that payments made in good faith in pursuance of a plan designed to improve the operation of the employer's business by providing for the welfare of its employees stands on a distinctly different footing from individual gifts or charities.[52] The fact that participation in an educational benefit trust is limited to selected, key employees does not preclude the deductibility of the employer's contribution as a business expense.[53] Additionally, numerous cases have upheld business expense deductions for payments to or for the benefit of spouses and dependents of employees.[54] Payment of benefits from an EBT to children of employees instead of directly to employees does not alter the employer's deduction under section 162. Finally, it should be noted that business expense deductions frequently have been allowed when the end result of the

49. 314 F.2d 953, 955, 956 (Ct. Cl. 1963) (business expense deduction allowed in year trust actually paid out funds).

50. *See, e.g.*, note 55 *infra* and accompanying text.

51. 42 F.2d 287 (D. Mass. 1930).

52. *Id.* at 288.

53. *See, e.g.*, Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968) (business deduction allowed for reimbursements of medical costs made only to key employees); *accord*, Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972).

54. Canaday v. Guitteau, 86 F.2d 303 (6th Cir. 1936) (payment of life insurance premiums for benefit of wife and daughter of corporation's president); Yuengling v. Commissioner, 69 F.2d 971 (3d Cir. 1934) (same); Corning Glass Works v. Lucas, 37 F.2d 798 (D.C. Cir. 1929) (contribution to local hospital; court notes benefits to dependents of employees); Jefferson Mills, Inc., v. United States, 259 F. Supp. 305 (N.D. Ga. 1965) (contribution to improve educational facilities for employees' children); American Factors, Ltd. v. Kanne, 76 F. Supp. 133 (D. Hawaii 1948), *rev'd on other grounds*, 190 F.2d 155 (9th Cir. 1951) (pension paid to widows and children of deceased employees); Estate of Hellstrom, 24 T.C. 916 (1955) (payment to widow of corporation's former president). *See also* Rev. Rul. 54-625, 1954-1 Cum. Bull. 85 (payment to widow of deceased employee).

corporate employer's expenditure was to provide educational, cultural, or medical benefits to employees or their dependents.[55]

Thus, regardless of whether contributions by a corporate employer to an educational benefit trust are characterized as compensation to the employee or as fringe benefits, the contributions satisfy the requirements of section 162 when scrutinized under the traditional requirements of being "ordinary and necessary" for a valid business purpose. The characterization of the contributions as compensation or fringe benefits, however, will determine both whether the deduction will be available under section 162 or under section 404(a)(5) and the time at which the deduction may be taken.

(2) Timing of Deduction

As shown above, the deductibility of an employer's contribution to an educational benefit trust is governed by the applicability of sections 404(a)(5), 83(h), and 162(a). If section 404(a)(5) applies to the transaction, the employer may deduct the contributions only in the year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, and only if the contributions also satisfy the conditions of section 162.[56] A similar result is contemplated under section 83(h),

55. Forbes Litbograph Mfg. Co. v. White, 42 F.2d 287 (D. Mass. 1930) (education of employee's children); Corning Glass Works v. Lucas, 37 F.2d 798 (D.C. Cir. 1929) (contribution to hospital); Jefferson Mills, Inc., v. United States, 259 F. Supp. 305 (N.D. Ga. 1965) (payment to improve local school); Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968) (medical); Weil Clothing Co., 13 T.C. 873 (1949) (educational and medical); Missouri Pac. R.R., 22 B.T.A. 267 (1931) (contribution to hospital); Sugarland Industries, 15 B.T.A. 1265 (1929) (contribution to hospital); Holt-Granite Mills Co., 1 B.T.A. 1246 (1925) (contribution to grade school).

56. *See* notes 23 & 25 *supra* and accompanying text. The timing of the employer's deduction is clarified further by Treas. Reg. § 1.404(a)-12 which provides:

> Section 404(a)(5) covers all cases for which deductions are allowable under Section 404(a) but not allowable under Paragraph (1), (2), (3), (4) or (7) of such section. No deduction is allowable under Section 404(a)(5) for any contribution paid or accrued by an employer under a stock bonus, pension, profit-sharing, or annuity plan, or for any compensation paid or accrued on account of any employee under a plan deferring the receipt of such compensation, except in the year when paid, and then only to the extent allowable under Section 404(a).
>
> See § 1.404(a)-1. If payments are made under such a plan and the amounts are not deductible under the other paragraphs of Section 404(a), they are deductible under Paragraph (5) of such subsection to the extent that the rights of individual employees to, or derived from, such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid. . . . If an amount is accrued but not paid during the taxable year, no deduction is allowable for such amount for such year. If an amount is paid during the taxable year to a trust, or under a plan and the employee's rights to

relating to transfers of property in connection with the performance of services.[57] If neither of these sections is applicable, the employer will be entitled to an immediate deduction in the year of contribution to the EBT under section 162, rather than delaying the deduction until actual disbursement of benefits by the trustees.[58] Thus, for an EBT plan to accomplish the tax goals of the corporate employer, it must avoid the application of the restrictive sections 404(a)(5) and 83(h).

By the express language of section 404(a), that section applies (1) "if contributions are paid by an employer to or under a stock bonus, pension, profit-sharing or annuity plan" or (2) "if *compensation* is paid or accrued on account of any employee under a plan deferring the receipt of such *compensation*."[59] The Service has interpreted this language to encompass "any method of contributions or compensations having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation."[60] While the use of the term "any method . . . having the effect of" may suggest a broad interpretation of the statute, the Service expressly has imposed limitations on the scope of section 404(a) in Regulation section 1.404(a)-1(a)(2), which states that section 404(a) does not apply to a plan "which does not defer the receipt of *compensation*." Furthermore, section 404(a) does not apply to deductions for contributions under a plan that is solely a "dismissal wage or unemployment benefit plan, or a sickness, accident, hospitalization, medical expense, recreation, welfare *or similar benefit plan*, or a combination thereof."[61] An examination of the legislative history of section 404(a) gives further support to the proposition that its applicability is limited to contributions or

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such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

57. *See* note 27 *supra* for actual language of § 83(h).

58. This conclusion is supported by the Regulations under Section 162. Treas. Reg. § 1.162-10(a) (1958) states:

> Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare or similar benefit plan, are deductible under Section 162(a) if they are ordinary and necessary expenses of the trade or business. However, . . . such amounts shall not be deductible under Section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in § 404(a).

See also note 29 *supra*.

59. INT. REV. CODE OF 1954, § 404(a) (emphasis added).

60. Treas. Reg. § 1.404(b)-1 (1960).

61. Treas. Reg. § 1.404(a)-1 (a)(2) (1963) (emphasis added).

payments in the nature of *compensation*. The predecessor of section 404 was enacted in the Revenue Act of 1942 as an amendment to section 23(p) of the Internal Revenue Code of 1939. As originally introduced in the House, the bill provided in part as follows:

> If *compensation* for personal services rendered is paid or accrued on account of any employee under a stock bonus, pension, profit-sharing or annuity plan or *similar plan* deferring the receipt of such *compensation*, then such *compensation* shall not be deductible under Subsection (a) but shall be deductible, if deductible under Subsection (a) without regard to this subsection, under this subsection but only to the following extent:
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> . . . .
>
> If there is no plan but the method of compensating for personal services has the effect of a stock bonus, pension, profit-sharing or annuity plan, or *similar plan deferring the receipt of compensation*, this paragraph shall apply as if there were such a plan.[62]

As ultimately enacted after revision by the Senate, section 23(p) referred to "contributions" rather than "compensation" in order to accord with the general usage and the provisions of section 165 of the Revenue Act of 1942.[63] Therefore, both the literal language and the legislative history of section 404(a), as well as the regulations promulgated thereunder by the Commissioner, support the proposition that if a contribution by an employer to a trust fund for the benefit of its employees cannot be properly characterized as "compensation," then section 404(a) is not applicable to the transaction and a deduction under section 162 may be taken by the employer in the year of the contribution if the conditions for a deduction under that section are met and no other section of the Code prohibits such immediate deduction.[64]

Recent Tax Court cases dealing with the application of section 404(a) to various employee benefit arrangements buttress this interpretation. In *New York Post Corp.*,[65] section 404(a) was applied by the court to a plan under which the corporate taxpayer accrued funds to provide payments on retirement or death of employees, thus preventing any deduction by the employer until payments were actually made to employees or their beneficiaries. The multipurpose, nonqualified plan provided for payment of benefits upon the employee's reaching age sixty-five or completing twenty-five years of service and voluntarily terminating his employment. Upon

62. H.R. REP. No. 7378, 77th Cong., 2d Sess. 113-16 (1942), (emphasis added). *See also* the report of the House Ways and Means Committee regarding the scope of the proposed amendment. H.R. REP. No. 2333, 77th Cong., 2d Sess. (1942).

63. S. REP. No. 1631, 77th Cong., 2d Sess. (1942).

64. *See* Henkel & Hackett, *supra* note 14, at 347-48; Teschner, *supra* note 17.

65. 40 T.C. 882 (1963).

satisfaction of these alternative conditions, the employee could not be deprived of his beneficial interest in the payments. The plan further provided that upon the employee's death any unpaid benefits would be payable to the employee's beneficiary. Labelling the payments as "compensation," the accrual-basis taxpayer claimed a deduction under section 162 since the liability was determinable and fixed during the taxable years in question. In reaching the conclusion that section 404(a) barred an immediate deduction, the court quoted relevant legislative history for the proposition that:

> If an employer on the accrual basis defers paying any compensation until a later year or years under an arrangement having the effect of a stock bonus, pension, profit-sharing or annuity plan, or similar plan deferring the receipt of compensation, he will not be allowed a deduction until the year in which the compensation is paid.[66]

The court then reasoned that the benefits were deferred compensation since they were so labeled by the taxpayer and were in addition to the employees' salary. Finding that the employees' rights were nonforfeitable and that the payments were neither "primarily" or "solely a dismissal wage plan" within Regulation section 1.404(a)-1(a)(2),[67] the court concluded that section 404(a) prevented any deduction until payments to employees were actually made. The court's application of section 404(a) to the plan appears to have turned on its finding that the payments were deferred compensation and were not excluded from the scope of that section by the regulations.

In *Champion Spark Plug Co.*,[68] section 404(a) was held inapplicable to installment payments of a deceased employee's salary to the employee's widow since the court found that the payments did not represent deferred compensation. The employee was hired in 1945 as a traveling representative of the company, and, although the corporate taxpayer had a pension plan for all employees financed by the company's purchase of insurance, the employee was excluded from the plan because he was uninsurable due to his extensive traveling. Prior to the employee's death from terminal cancer, the employer adopted a resolution to pay him a sum equal to thirty times his monthly salary in sixty equal semi-monthly installments and, at his death, to continue payments to his wife. The employer, an accrual-basis taxpayer, accrued the payment and took a deduction

66. H.R. REP. No. 2333, 77th Cong., 2d Sess., 106 (1942).

67. *See* note 56 *supra* and accompanying text.

68. 30 T.C. 295 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959) (decided under the INT. REV. CODE OF 1939).

for the full amount in 1953. In responding to the Service's argument that section 23(p) of the 1939 Code[69] prevented an immediate deduction in 1953, the court concluded that the expenditures by the corporate taxpayer did not constitute the payment of compensation under any plan deferring the receipt of compensation so as to render section 23(p) applicable. The court based its conclusion that the payments were not compensation on its finding that the employee had been paid fully for all past services rendered to the employer.[70]

The most recent and in-depth analysis of section 404(a) is contained in *Latrobe Steel Co.*,[71] in which the court considered whether an extended vacation plan[72] for employees that contemplated payment of vacation benefits in years subsequent to funding the plan constituted a plan deferring the receipt of compensation within the meaning of section 404(a). In holding that the plan was outside section 404(a), the court undertook an extensive review of the legislative history of the statute and "concluded that a plan deferring the receipt of compensation is subject to the rules of section 404(a) only if it is similar to the four types of plans enumerated."[73] The court then stated:

> Although the extended vacation plan presently in issue results in the deferral of compensation, we do not find that this plan is similar to a stock bonus, pension, profit-sharing or annuity plan. The plan is unlike either a pension or annuity plan since it is not designed to provide benefits to employees upon retirement. Furthermore, the plan is unlike a profit-sharing or stock bonus plan since it is not designed to grant employees a share of the employer's profits and thereby create an incentive to contribute to the success of the employer. The compensation received by an individual while on vacation is measured neither by reference to retirement needs nor employer profits. We, therefore, hold that the extended vacation plan in issue is not subject to the rules of section 404 but rather is controlled by section 162.[74]

The cumulative result of these cases seems to indicate that section 404(a) does not apply to contributions by an employer to an employee benefit plan (1) when those contributions are not in the nature of "compensation," and (2) when the plan, even though re-

69. Now § 404(a) in the INT. REV. CODE OF 1954. *See* text accompanying note 57 *supra*.

70. 30 T.C. at 300.

71. 62 T.C. 456 (1974).

72. The plan provided that any employee who had one or more years of continuous service and who had not been absent from work for six continuous months or more in the preceeding year would be eligible for a regular vacation and an extended vacation of seven to thirteen weeks of time off with pay once in each five year period. After rights to extended vacation vested, the employee would not forfeit them even though employment terminated. The employer retained the right to determine when the vacations would be taken.

73. 62 T.C. at 464.

74. *Id.* at 465.

sulting in the deferral of "compensation," is designed neither to provide benefits to employees upon retirement nor to grant employees a share of the employer's profits. Since contributions to an educational benefit trust are not intended to be compensation to the employees, being based on a standard unrelated to the quality or quantity of services rendered by the employees,[75] and are designed neither to provide retirement benefits to employees nor to grant them a share of the employer's profits, the deductibility of such contributions would seem to be unaffected by section 404(a)(5).

Even if contributions to EBTs are held to be outside the scope of section 404(a), they must also be outside section 83(h) if the employer is to be allowed an immediate business expense deduction under section 162. By its express terms, section 83 applies to any transaction in "which property is transferred in connection with the performance of services, to any person other than the person for whom such services are performed."[76] Despite this all-embracing language, EBT contributions arguably may escape section 83 in either of two ways. The first escape route is found in the definition of "property" in Proposed Regulation § 1.83-3(e) as including "both realty and personalty *other than money* and *other than an unfunded and unsecured promise to pay deferred compensation.*"[77] The typical funding method used in educational benefit trusts is an annual contribution of cash by the employer. Although the employer's promise to contribute to the trust fund is not a "promise to pay deferred compensation," the promise is "unsecured" and "unfunded" and this is analogous to the exception from the definition of "property." If this technical argument seems tenuous, the second escape route from section 83 provides legislative policy to support the inapplicability of the section to noncompensatory payments. The legislative history of section 83[78] indicates that Congress intended section 83 to apply only in situations in which property is transferred as compensation to the employee or independent con-

75. The level of contributions made by an employer to an EBT is based on the estimated expenses to be incurred by all partipating children of eligible employees in attending educational institutions. The amount of such contributions is in no way related to the salaries of employees covered by the plan. *See* text accompanying notes 17-19 *supra*.

76. INT. REV. CODE OF 1954, § 83(a). Proposed Treas. Reg. § 1.83-3(f) (1971) defines "property transferred in connection with the performance of services" to include "property transferred to an employee or an independent contractor or beneficiary thereof in recognition of the performance of services . . . whether such transfer is in respect of past, present, or future services."

77. Proposed Treas. Reg. § 1.83-3(e) (1971) (emphasis added).

78. Section 83 was added to the Code by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 321(a).

tractor and not to apply to noncompensatory fringe benefits.[79] In summary, section 83 does not apply to EBTs so as to prevent an employer from deducting contributions in the same year in which they are made because such contributions do not represent property within the meaning of the statute and because section 83 applies only to transfers of property intended as compensation to the transferee and not to transfers which are not compensatory.

Thus the success and usefulness of EBTs depends on the ability of participants to prove that contributions should be characterized as fringe benefits and not as compensation. If the contributions are characterized as fringe benefits enabling the taxpayer to avoid sections 404(a) and 83(h), the employer will be entitled to an immediate deduction under section 162 since educational benefit trust plans fall within the "similar benefit plan" language of the regulations under section 162, being as worthy of favorable tax treatment as are "medical, recreational or welfare benefit plans."[80]

The argument that contributions to educational benefits trusts are not "compensation" to the employees is further supported by the propositions that not every benefit conferred upon employees by an employer represents compensation[81] and that no necessary corre-

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79. *See, e.g.*, Senate Fin. Comm. Report on Pub. L. No. 91-172 in P-H 1976 FED. TAXES ¶ 7923, which provides that

> [t]his rule [relating to cancellation of restrictions on property that by their terms will never lapse] is not to apply, however, if the owner of tbe property can establish that the cancellation is not *compensatory* and that the person who would be entitled to a deduction if it were compensatory will not treat the transaction as compensatory. . . . The committee provided rules for the employer's deduction for restricted property given to employees as *compensation*. The allowable deduction is the amount which the employee is required to recognize as income. . . . Where restricted property is not subject to the new rules governing recognition of income, existing rules regarding the amount of the deduction will continue to apply. (emphasis added)

80. *See* note 58 *supra*. *See also* text accompanying notes 41-55 *supra* regarding the "ordinary and also necessary" test of § 162. The residual role of § 162 was demonstrated by the treatment of the taxpayer in *Latrobe Steel*, 62 T.C. 456 (1974), in which the court held that the extended vacation plan was not subject to the rules of § 404(a) and, therefore, was governed by § 162. The Service's objection to an immediate deduction under § 162 is due largely to the fact that the employer's deduction for contributing to an EBT would come in a taxable year prior to the year in which benefits paid out from the trust would be reported as gross income to the beneficiary. This result is not unknown in the complex world of federal income taxation. *See, e.g.*, Kershaw Mfg. Co. v. Commissioner, 313 F.2d 942 (5th Cir. 1963); Avco Mfg. Corp., 25 T.C. 975 (1956); Produce Reporter Co., 18 T.C. 69 (1952); Rev. Rul. 61-127, 1961-2 CUM. BULL. 36; Rev. Rul. 57-88, 1957-1 CUM. BULL. 89 (allowing deduction for employee bonus based on year-end profits when payments are made in later taxable year due to necessity of awaiting the closing of the employer's books).

81. *See* Diamond v. Sturr, 221 F.2d 264 (2d Cir. 1954) (food and lodgings); Latrobe Steel Co., 62 T.C. 456 (1974) (extended vacation); S.J. Campbell, 20 CCH Tax Ct. Mem. 825 (1961) (customer parties at taxpayer's apartment paid for by employer); Champion Spark Plug Co.,

lation exists between the payor's right to a deduction for a payment and the taxability of the payment to the recipient.[82] The Service has promulgated regulations giving nineteen examples of noncompensatory fringe benefits, many of which are not insubstantial in terms of cost to the employer or value to the employee.[83] Cases distinguishing compensation from noncompensatory benefits or payments tend to focus upon whether the parties intended the payments to be compensatory, whether the person receiving the benefit was required to perform additional services for the payor, and whether the recipient had been fully compensated for past services rendered. In *Paula Construction Co.*,[84] the court denied a business expense deduction to the corporate taxpayer for distributions made to shareholder-officers over the taxpayer's claim that the distributions were compensation, relying on the settled rule of law that the deductibility of payments claimed to be compensation is dependent upon a factual finding of an intention to compen-

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30 T.C. 295 (1958) (death benefit paid to widow of employee); William Schoenheit, 14 B.T.A. 33 (1928) (rental value of home owned by employer).

82. Zeunen Corp. v. United States, 227 F. Supp. 952 (E.D. Mich. 1964); Fifth Ave. Coacb Lines, Inc., 31 T.C. 1080 (1959), *rev'd on other grounds*, 281 F.2d 556 (2d Cir. 1961); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 6.02 (1974).

83. Proposed Treas. Reg. § 1.61-16, 40 Fed. Reg. 41118 (1975). In addition to the examples of fringe benefits given in the regulation, it also provides factors that, although not necessarily controlling, tend to indicate that the benefit does not constitute compensation. These include:

(1) The cost incurred by the employer in providing the benefit is not identifiable or significant in relation to the value of the benefit received by the employee.

(2) The use of the benefit occurs during, or immediately before or after, working hours at or near the business premises of the employer and has a proximate relation to work performed by the employee.

(3) The benefit is provided to employees generally or to reasonable classifications of employees determined, for example, on the basis of the nature of their work, seniority, or similar factors but not classifications primarily including only the most highly compensated employees.

(4) The benefit is similar to a service or other benefit that is commonly provided by state or local governments in the United States, hut which is not readily available to the employees because of the location of their employment.

(5) The benefit accommodates an important requirement of the employer or relieves the employer of significant expense or inconvenience.

(6) The benefit is reimbursement of a greater than usual item of expense that was incurred by the employer for a purpose normally thought primarily personal, but that was incurred hecause a business requirement of the employer prevented the employee from ohtaining the item in the ordinary manner.

(7) The benefit is provided primarily to insure the employee's safety by protecting against a significant risk arising from the employment relation.

(8) The benefit is not a substantial amount absolutely or in comparison to the employee's stated compensation.

(9) The item generally is not thought of as constituting compensation includible in gross income.

84. 58 T.C. 1055 (1972).

sate.[85] Analogously, in cases dealing with what constitutes "wages" for income tax withholding purposes under section 3401,[86] the fact that employees were not required to perform any additional services in order to receive the benefits at issue was held to be of primary significance in the court's conclusion that the payments were not "wages."[87] The court's finding that a deceased employee had been compensated adequately during life resulted in its holding that payments by the employer-corporation to the employee's widow were not "compensation" in *Champion Spark Plug Co.*[88] Conversely, a finding that an employee had not been fully paid for past services was held to establish the compensatory nature of later payments to the employee's widow in *Fifth Avenue Coach Lines, Inc.*[89]

Therefore, when contributions to EBTs are compared to the above considerations for determining whether payments by an employer constitute compensation, the payments should be deemed noncompensatory fringe benefits.[90] The level of funding of an educational benefit trust is determined by estimations of future educational expenses to be incurred by eligible children, which are related neither to salary levels of employees covered by the plan nor to the value of the services rendered by them. Participation is not limited to shareholders or officers, but encompasses all key employees. Employees and their children are not required to perform additional services for the employer in order to receive the educational benefits, and all services rendered previously have been adequately compensated. Contributions by the employer are motivated by a desire to increase employee goodwill, faithfulness, loyalty, and efficiency and are not intended as compensation for the rendition of past, present, or future services. While this argument is the backbone of the availability of the employer's deduction under section 162, and

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85. 58 T.C. at 1058-59, citing Charles McCandless Tile Serv. v. United States, 422 F.2d 1336, 1339 (Ct. Cl. 1970); Northlich, Stolley, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966); Irby Constr. Co. v. United States, 290 F.2d 824, 826 (Ct. Cl. 1961); *accord*, Diamond v. Sturr, 221 F.2d 264 (2d Cir. 1954); Allen Indus., Inc., 27 CCH Tax Ct. Mem. 542 (1968), *aff'd*, 414 F.2d 983 (6th Cir. 1969); Fifth Ave. Coach Lines, Inc., 31 T.C. 1080 (1959), *rev'd on other grounds*, 281 F.2d 556 (2d Cir. 1961).

86. INT. REV. CODE OF 1954, § 3401.

87. Stubbs, Overbeck & Assoc., Inc. v. United States, 445 F.2d 1142 (5th Cir. 1971) (living allowance for employees at remote job site); Royster Co. v. United States, 342 F. Supp. 375 (E.D. Va. 1972) (reimbursement for meals of travelling salesmen); Humble Pipe Line Co. v. United States, 442 F.2d 1353 (Ct. Cl. 1971) (payment of moving expenses of transferred employees).

88. 30 T.C. 295 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959); *accord*, Allen Indus., Inc., 27 CCH Tax Ct. Mem. 542 (1968).

89. 31 T.C. 1080 (1959).

90. *See* Henkel & Hackett, *supra* note 14; Teschner, *supra* note 17.

thus determinative of the entire future of educational benefit trusts, no case has analyzed the argument in the context of an EBT arrangement.

(3) Taxation Upon Disbursement

The most desirable treatment of disbursements from EBTs, from the taxpayer's viewpoint, is to exclude the payments from the gross income of the recipient under section 117 as a scholarship.[91] Alternatively, if exclusion is denied, the named beneficiaries of the trust, the eligible children of participating employees, should be taxed for the benefits received from the trust at the time payments actually are received by them. Although this second argument does not result in tax-free receipt of benefits from the EBT, it does allow deferral of taxation and the splitting of taxable income within the family. Therefore, the family income is taxed at a lower effective rate than if the employee-parent was taxable upon the full amount of his salary plus the benefits received from the trust.

The general rule regarding the taxation of scholarships is provided by section 117(a), which provides in part that "gross income does not include any amount received as a scholarship at an educational institution . . . or as a fellowship grant . . . ."[92] Although the statute does not define the term "scholarship,"[93] a definition is provided by the regulations, which state:

> A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations . . . and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as part of a scholarship.[94]

Although this definition seems pervasive, the Service has indicated its true disdain for the congressionally provided tax break by imposing severe limitations upon that definition in subsequent regulations. Regulation section 1.117-3(a) excludes from the definition of "scholarship" "any amount provided by an individual to aid a relative, friend, or other individual in pursuit of his studies where the grantor is motivated by family or philanthropic considerations."[95] A

91. INT. REV. CODE OF 1954, § 117.

92. *Id.*

93. The statute does define "educational institution" by reference to § 151(e)(4) of the Code.

94. Treas. Reg. § 1.117-3(a) (1960).

95. *Id.*

further limitation is contained in the controversial Regulation section 1.117-4(c), which excludes from the definition of "scholarship" both amounts paid as compensation for past, present, or future employment services and amounts paid to enable an individual to pursue studies primarily for the benefit of the grantor of the payments. Additionally, the regulation establishes a test for the exclusion of amounts paid to an individual to enable him to pursue studies on research. If the "primary purpose" of the studies is to further the education of the recipient in his individual capacity and the amount paid does not represent compensation for services, the payment is excludable.[96] Until the Supreme Court's decision in *Bingler v. Johnson*,[97] the lower courts had applied the exclusion of section 117 under the "primary purpose" test.[98]

Bingler v. Johnson, the first interpretation of section 117 by the Supreme Court, represents an important victory for the Service. Although the precise holding of the case may not be objectionable, the loose language employed by the Court in concluding that the stipends received by the taxpayers were not scholarships may foreclose exclusion under section 117 when educational benefits are awarded by any reference to an employment nexus. In *Johnson*, the taxpayers, while on educational leave from their employment by Westinghouse Electric Corporation, received a stipend from Westinghouse in an amount based on a specified percentage (seventy to

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96. Treas. Reg. § 117-4 (1960), which, in part, provides:

> The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:
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> . . .
>
> (c)(1) . . . any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, *if such amount represents either compensation for past, present, or future employment services* or represents payment for services which are subject to the direction or supervision of the grantor.
>
> (2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.
>
> However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of *section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph.* Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant. (emphasis added).

97. 394 U.S. 741 (1969).

98. *See* Wrobleski v. Bingler, 161 F. Supp. 901, 905 (W.D. Penn. 1958), citing Treas. Reg. § 1.117-4(c) (1960).

ninety percentum) of their prior salaries plus "adders" depending upon family size. Taxpayers further retained their seniority status, received all employee benefits such as insurance and stock options, and were required to agree in writing to return to the employ of Westinghouse for at least a two-year period following their leave of absence. Westinghouse deducted the stipends as an "indirect labor expense," and the taxpayers claimed they were excludable under section 117. The Service, however, determined that the stipends were includable in the taxpayers' gross income. Holding that the stipends were not scholarships under section 117 but were includable in gross income, the Supreme Court stated that the definitions in section 1.117-4(c) of the regulations were prima facie proper, "comporting as they do with the ordinary understanding of 'scholarships' and 'fellowships' as relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipients,"[99] and that "a definition of 'scholarship' that excludes from the reach of that term amounts received as compensation for services performed" was not inconsistent with the legislative history of the statute.[100] The Court concluded by applying this new quid pro quo test to the facts in issue and held that the amounts received were taxable "compensation" rather than excludable "scholarships" due to the continued incidents of the employer-employee relationship and the obligation of the taxpayers to return to Westinghouse's employ after completion of their leaves.[101]

Bingler v. Johnson obviously represents a substantial stumbling block to claims by beneficiaries of EBTs that payments received by them are excludable as scholarships under section 117. Although some tax scholars suggest that the decision and subsequent rulings by the Service indicate that "the door to exclusion under section 117 is all but closed,"[102] beneficiaries of EBTs still may be able to qualify for exclusion. Certainly, under the quid pro quo test, the existence of the employment relationship between the grantor-employer contributing to the EBT and the parent of the recipient of the scholarship will cause the Service to scrutinize the arrangement closely. But the mere existence of the employment

99. 394 U.S. at 751.

100. *Id.* at 752. The Court also expressed "reluctance to believe that Section 117 was designed to exclude from taxation all amounts, no matter how large or from what source, that are given for the support of one who happens to be a student." *Id.* at 753.

101. *Id.* at 755-58.

102. *See* Clurman & Reiner, *Scholarship and Fellowship Grants: An Analysis of Factors Needed for Exclusion*, 39 J. TAXATION 150, 152 (1973).

relationship does not require the conclusion under *Bingler v. Johnson* that the payments received by the beneficiaries are not excludable as scholarships. As discussed above, contributions to EBTs are not compensation, but are more in the nature of non-compensatory, fringe benefits.[103] This argument is based on the premise that the employee-parent is fully compensated by his salary and other items of compensation for any past, present, or future services he might render to the employer. Such a finding resulted in the court's conclusion in *Laurence E. Broniwitz*[104] that the award received by the taxpayer was a scholarship, excludable under section 117, despite the fact that the taxpayer had received summer employment from the grantor. Furthermore, "no strings" are attached to the receipt of benefits from the trust. Beneficiaries are not required to perform services for the grantor either before or after attending the educational institution of their choice, nor are they required to pursue a particular course of study beneficial to the grantor as a condition of receiving payments from the trust. The Service's only argument is that the plan's requirement that the parent remain an employee of the grantor from the time of the first contribution by the employer until the beneficiary becomes eligible to receive payments from the trust is paramount to a "substantial *quid pro quo* from the recipient." The taxpayer can respond by arguing that the employee was fully compensated for all services rendered prior to the award of the "scholarship."[105] However appealing this line of reasoning may be from a taxpayer's viewpoint, the probability of successfully excluding benefits received from the trust as scholarships under section 117 is uncertain due to *Bingler v. Johnson*.[106]

If benefits received from educational benefit trusts are not excludable from gross income under section 117 as scholarships, the related questions of when and to whom such payments are taxable must be considered. The Service[107] and participants in EBT plans appear to be in agreement that contributions to such plans by em-

103. *See* notes 81-90 *supra* and accompanying text.

104. 27 CCH Tax Ct. Mem. 1088 (1968) (decided before the Supreme Court's decision in *Bingler v. Johnson* but after that of the Third Circuit). The court in *Broniwitz* stated that "[t[he respondent's assertion that the stipend was compensation for past or future services is contradicted by the evidence for, as we have pointed out, petitioner was paid for whatever part-time or summer work he performed for Raytheon at a rate commensurate with his abilities. . . ." *Id.* at 1093.

105. *See* note 99 *supra* and accompanying text.

106. *See* Henkel & Hackett, *supra* note 14, at 349-50; Teschner, *supra* note 17.

107. Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42.

ployers are not taxable until benefits actually are paid out to beneficiaries, but they are sharply divided as to against whom such payments are taxable. Taxpayers insist that the actual recipients of the awards, the children of the employees, are the proper persons to be taxed, whereas the Service, seeking to maximize the aggregate tax liability of the family unit, maintains that the parent-employees are taxable.

The statutory schemes of sections 451 and 402(b) provide alternative times at which an interest in an educational benefit trust might be taxed. The general rule, contained in section 451, provides that "[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer . . . ,"[108] receipt may be either actual or constructive.[109] Section 402(b) contains an alternative plan of taxing contributions to employees' trusts by providing that "[c]ontributions to an employee's trust . . . not exempt . . . under section 501(a) shall be included in the gross income of the employee in accordance with section 83. . ." and that "[t]he amount actually distributed or made available to any distributee by any such trust shall be taxable to him in the year in which so distributed or made available, under section 72 (relating to annuities). . . ."[110] Under section 83(a), the value of property transferred to a person in connection with the performance of services is includible in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in the property are transferable or are not subject to a substantial risk of forfeiture.[111] Due to the forfeitable and contingent nature of a beneficiary's interest in an EBT, application of sections 402(b) and 83(a) would result in the deferral of taxation until benefits actually are paid from the trust, a result desired by taxpayers; taxpayers, however, wish to avoid the application of those provisions for at least two reasons. First, section 83(a) requires that the person performing the services, not the person receiving the property, be taxable, and secondly, section 83(h) prevents any deduction by the contributor of the property until the value of the property is included in the gross income of the recipient. These results are contrary to the tax goals of taxation of benefits to the child-beneficiary and an immediate deduction by the employee.

108. INT. REV. CODE OF 1954, § 451.
109. *See* Treas. Reg. § 1.451-1(a) (1971).
110. INT. REV. CODE OF 1954, § 402(b). *See also* text accompanying note 34 *supra*.
111. INT. REV. CODE OF 1954, § 83(a). *See also* text accompanying note 35 *supra*.

The taxpayer's argument for avoiding sections 402(b) and 83(a) is similar to that of the employer with regard to section 404(a), as discussed above.[112] Sections 404(a)(5), 402(b), and 83 were enacted to provide a common scheme for the taxation and deduction of nonqualified deferred compensation arrangements.[113] Contributions to EBTs are not properly characterized as compensation but are in the nature of fringe benefits. Furthermore, contributions to such plans are outside the definition of "property" as that term is used in section 83.[114]

If sections 402(b) and 83(a) are not applicable to educational benefit trusts, taxation will follow the rules of section 451. Section 1.451-1(a) of the regulations elaborates on the general rule of section 451 regarding when an item of income must be reflected in a taxpayer's gross income by providing:

> Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy . . . . Under the cash receipts and disbursements method of accounting such an amount is includible in gross income when actually or constructively received.[115]

Thus, assuming that all beneficiaries of an EBT employ the cash receipts method of accounting, no tax liability will arise from their beneficial interest in the trust fund until benefits are actually received from the trustee, unless the Service can show that the doctrine of constructive receipt applies to require taxation at an earlier time. The doctrine of constructive receipt provides that when items of income are available to a taxpayer in a taxable year, although not actually received by him, and the taxpayer's failure to receive such items is due solely to his own volition, those amounts will be regarded as constructively received by the taxpayer during that taxable year.[116] The policy underlying this doctrine is that a taxpayer should not be allowed deliberately to refuse income and

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112. *See* notes 59-79 *supra* and accompanying text.

113. Henkel & Hackett, *supra* note 14, at 348. *See also* notes 62, 63 & 79 *supra* (relating to the legislative history of §§ 404(a) & 83).

114. *See* note 77 *supra* and accompanying text.

115. Treas. Reg. § 1.451-1(a) (1971).

116. *See* Corliss v. Bowers, 281 U.S. 376 (1930); Loose v. United States, 74 F.2d 147, 150 (8th Cir. 1934); Richard R. Deupree, 1 T.C. 113 (1943); 1 J. MERTENS, *supra* note 82, at § 9.02; Moore, *Problems in Nonqualified Deferred Compensation*, 25 TAX EXEC. 108, 109 (1971-72). *See also* Ross v. Commissioner, 169 F.2d 483 (1st Cir. 1948).

thus select the year in which he will report it.[117] For the doctrine to be applicable the taxpayer must be entitled to receive the income immediately, the income must be available to him immediately, and his failure to receive it in cash must be due entirely to his own volition.[118] The test for applying the doctrine of constructive receipt, as developed by the courts, is whether the apparent limitations that prevent the taxpayer from receiving the payment during the current rather than a later taxable year are merely a sham.[119] This test is consistent with the Service's regulations, which state that "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."[120] Application of this doctrine to contributions to employee trusts is illustrated by various rulings by the Service holding that when the contribution results in a fully vested and nonforfeitable interest in the employee, the contribution must be reported as income in the year contributed; if contributions are made to a nonfunded plan subject to substantial forfeiture provisions, however, no income need be reported in the year of contribution.[121] While numerous cases deal with the issue of what constitutes a substantial risk of forfeiture or a contingent right to receive income,[122] the most comprehensive discussion of the doctrine of constructive receipt is contained in Revenue Ruling 60-31,[123] which provides several examples of deferred compensation arrangements that escape taxation in the year of contribution. This ruling suggests various forfeiture provisions that may be used to prevent the application of the constructive receipts doctrine, including the taxpayer's engaging in any business in competition with his employer-grantor or the taxpayer's failure to make himself available to the employer for consultation and advice.

The constructive receipts doctrine, when applied to the typical

117. 2 J. MERTENS, *supra* note 82, at § 10.01.

118. 1 J. MERTENS, *supra* note 82, at § 9.02. *See also* Treas. Reg. § 1.451-2(a) (1971).

119. Behlmer D. Laramy, 25 CCH Tax Ct. Mem. 809 (1966); John A. Brander, 3 B.T.A. 231 (1925).

120. Treas. Reg. § 1.451-2(a) (1971).

121. *Compare* Rev. Rul. 57-528, 1957-2 CUM. BULL. 263; Rev. Rul. 57-37, 1957-1 CUM. BULL. 18; Rev. Rul. 55-691, 1955-2 CUM. BULL. 21 *with* Rev. Rul. 71-419, 1971-1 CUM. BULL. 220; Rev. Rul. 67-449, 1967-2 CUM. BULL. 173.

122. *See, e.g.*, Commissioner v. Hansen, 360 U.S. 446 (1959); North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932); Burnet v. Logan, 283 U.S. 404 (1931); Drysdale v. Commissioner, 277 F.2d 413 (6th Cir. 1960); Behlmer D. Laramy, 25 CCH Tax Ct. Mem. 809 (1966); E.T. Sproull, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Willis R. Dearing, 36 B.T.A. 843 (1937); Edwards Drilling Co., 35 B.T.A. 341 (1937); William Schoenheit, 14 B.T.A. 33 (1928).

123. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174.

educational benefit trust plan, should not result in taxation of the benefits prior to actual disbursement. The limitations on the beneficiary's right to receive payments from the trust are substantial and are not due to his own volition. The child's rights in the fund become vested and nonforfeitable only upon the occurrence of three events: the child's becoming a candidate for a degree at an accredited educational institution, the child's actually incurring educational expenses, and the parent's remaining an employee of the grantor from the time of the original contribution until the child enters school and incurs expenses. If any of these conditions of forfeiture is not complied with, the child receives nothing. That these limitations are substantial and not merely a sham is supported by the natural business motive of the employer in insisting that the beneficial interest be forfeited if the parent terminates his employment. At no time prior to the occurrence of these three events is there any possibility of the employee or his child receiving anything from the trust. Therefore the owner of a beneficial interest in such an educational trust should be taxable, if at all, when payment of benefits actually is made under the general rules of sections 61 and 451 and not pursuant to sections 402(b) and 83(a).

The question of who is taxable for payments from EBTs is a major point of disagreement between taxpayers and the Service. Taxpayers insist that the child of the employee is the recipient of the income both in form and in substance. Only the child can receive the benefits, never the parent. The payments discharge no legal obligation of the parent and the mere satisfaction of familial desires cannot be a valid basis for assigning the income to the parent. The Service, having at its disposal several judicial doctrines designed to avoid contrived, technical arguments based on statutory construction, attempts to include the payments in the gross income of the parent. The Service may rely on one of the newer doctrines, the so-called "generation theory," in its attack on educational benefit trusts.[124] If applicable, this doctrine would determine the time of taxability as well as who is taxable.

The generation theory requires income produced by the rendition of services to be taxed in the year the services were rendered, despite the right to receive the income being subject to contingencies and conditions of forfeiture, when such restraints on the right to receive the income are the result of bargaining between the employee and the employer. The government need not prove that the

124. Teschner, *supra* note 17.

taxpayer had complete and unrestricted power to designate the manner and form in which the income would be received. The theory is similar to the anticipatory assignment of income doctrine, but without the requirement that the taxpayer have the unrestricted right to receive the income at the time it was assigned. This theory purportedly is the underlying basis for the Supreme Court's recent decision in *United States v. Basye*.[125] In *Basye* a partnership, Permanente Medical Group, contracted with Kaiser Foundation Health Plan, Inc., to provide medical services to members of Health Plan. The contract required Health Plan to pay a "basic compensation" to the partnership and, as an incentive for the physicians to remain with the partnership and serve Health Plan, to pay amounts labelled "partial compensation," into a retirement plan trust. The participants' interest in the fund was determined by salary, past service, and age when entering the partnership. The interest was contingent upon remaining with the partnership for fifteen years of continuous service or until age sixty-five or death, and was forfeitable upon serving competitors or refusing to render services to Health Plan. Under the contract, these payments were to be used solely to fund the retirement plan trust and were not otherwise available to the partnership. The Commissioner determined that the partnership should have reported these payments as income and that each partner's share of partnership income thus was understated. The Commissioner argued that the taxable nature of the payments must be determined at the partnership level, and that the partnership's right to the payments was fixed and unconditional. Therefore, the Commissioner contended that each partner's "distributive share" of the payments should be taxed immediately since the partners had "generated" the deferred compensation income. The trial court held for the taxpayers on the grounds that the "generation theory" was contrary to the doctrine of assignment of income because the partnership never had a right to receive the income and that the contingent and forfeitable nature of the payments prevented immediate taxability.[126] After affirmance by the Court of Appeals,[127] the Supreme Court reversed, holding that the partners properly were taxable on the retirement fund income under the assignment of income doctrine and under the policy that partners are taxable on their distributive share of current partnership

125. 410 U.S. 441 (1973); *see* Teschner, *supra* note 17.
126. Basye v. United States, 295 F. Supp. 1289 (N.D. Cal. 1968).
127. United States v. Basye, 450 F.2d 109 (9th Cir. 1971).

income irrespective of whether that income actually is distributed to them.[128] The reasoning of the Court seems to have been that the payments were compensation, that once received the payments were not forfeitable by the partnership, that only the individual interests of each partner or employee were forfeitable, and that therefore the partners were taxable on their distributive share of the partnership income. While not expressly mentioning the generation theory, the Court did state that the government was not required to prove that the partnership had agreed to accept less direct compensation in return for the contingent, deferred trust benefits. The motive of Health Plan in making the payments to the trust was said to be irrelevant to the characterization of the amounts as compensation.[129] Of particular relevance to the EBT plan is the Court's statement that:

> For purposes of income tax computation it made no difference that some partners might have elected not to participate in the retirement program or that, for any number of reasons, they might not ultimately receive any of the trust's benefits. Indeed, as the Government suggests, the result would be quite the same if the 'potential beneficiaries included no partners at all, but were children, relatives, or other objects of the partnership's largesse.' The sole operative consideration is that the income had been received by the partnership, not what disposition might have been effected once the funds were received.[130]

Arguably the *Basye* decision does not represent a radically new inclination by the Court to assume that any contractual compensation arrangement producing less than the most drastic tax consequences to the participants is a mere contrivance that may be restructured by the Service to increase taxability.[131] Instead, as stated by the Court, the case was "controlled by familiar and long settled principles of income and partnership taxation."[132] The Court's characterization of the contributions to the trust as compensation appears inevitable since they were so labelled in the Health Plan contract. Furthermore, the inclusion of the payments in partnership income was necessitated by a clause in the partnership agreement providing that all earnings from services would inure to the exclusive benefit of the partnership and that all partners would be limited in income to a distributive share of partnership earnings. This

128. 410 U.S. 441, 447-48 (1973).

129. *Id.* at 451-52.

130. *Id.* at 456, citing Brief for Appellant at 21.

131. *But cf.* Teschner, *supra* note 17, at 339, which suggests that the Commissioner is now likely to attempt to tax currently any payments, no matter how contingent or forfeitable, and no matter to whom payable, that are "concurrent with services" by a taxpayer.

132. 410 U.S. at 457.

provision made the only issue in the decision one of when, not whether, the contributions would be includible in partnership income. The Court did not disregard the principle that forfeitability precludes inclusion in gross income, but found the contributions, once paid, to be nonforfeitable to the partnership, although each beneficiary's interest in the trust remained forfeitable. The Court did not disturb the settled principle that when an interest in an employee's trust is forfeitable at the time the contributions are made, such an interest is not taxable at that time.[133] While the *Basye* opinion does contain dictum indicating that proof by the Service that the taxpayers agreed to receive less direct compensation in return for the deferred compensation contributions is not required, an attempt by the Service to apply this approach to any and every transaction probably would be denied due to the high regard traditionally given to arm's-length bargaining. The Service itself has supported such a conclusion by ruling that " . . . the statute [section 451] cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment."[134] The courts also have recognized the folly of attempting to look behind arm's-length bargaining. Discussing the doctrine of constructive receipt, one court stated that "a bona fide contract providing for deferred payments . . . [will] be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time."[135] Furthermore, the idea that the mere "generation" of income when coupled with the power to divert it elsewhere requires taxation to the "generator" seems inconsistent with the court's statement in *Nicholas A. Stavroudis* that "[i]t is settled that a power to direct the distribution of trust income to others is not alone sufficient to justify the taxation of that income to the possessor of such a power."[136] Consequently, the *Basye* decision appears to have little application outside its specific facts.

A judicial doctrine similar to the generation theory is the doctrine of anticipatory assignment of income. This doctrine provides that a person who is entitled to receive income at a future date and who makes a gift of such income to another by assignment will be

133. *See* Harold G. Perkins, 8 T.C. 1051 (1947), *acquiesced in*, 1947-2 CUM. BULL. 3; Julian Robertson, 6 T.C. 1060 (1946), *acquiesced in*, 1946-2 CUM. BULL. 4.

134. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174, at 178.

135. Oliver G. Willits, 50 T.C. 602, 613 (1968), *citing* Ray S. Robinson, 44 T.C. 20, 36 (1965); J.D. Amend, 13 T.C. 178 (1949); W.J. Gullett, 31 B.T.A. 1067 (1935).

136. 27 T.C. 583, 590 (1956). *See also* Commissioner v. Giannini, 129 F.2d 638 (9th Cir. 1942).

held to have realized taxable income as though he had collected the income and paid it directly to the assignee.[137] For the doctrine to apply, the assignor's right to receive payment must be fully vested and subject to no contingencies at the time of the assignment, as was clearly stated in *Cold Metal Process Co. v. Commissioner.*[138] There a corporation had sued several other companies for patent infringement. The government subsequently sought to cancel the patents after impounding all damages awarded in the prior suits. Each shareholder then sold his stock to a trustee for cash and a percentage of damages in the event the impoundment order was lifted. Although all suits were settled by 1945, the impoundment order remained in effect until 1949. In holding that there was no accrual of income to the corporation in 1945, the court stated that there was no anticipatory assignment of income since the assignor was not vested with a right to receive the income at a future date at the time of the assignment.[139]

The Service may attempt to apply the assignment doctrine to EBT arrangements to make the parent-employee, rather than child, taxable for the disbursements by arguing that the parent need only have a legal right to receive the income and that restrictions on that right due to a consensual agreement between the employer and employee do not prevent application of the doctrine. Such an interpretation seems to be completely at odds with cases such as *Paul A. Teschner.*[140] Mr. Teschner entered, and subsequently won, a contest whose rules precluded him from being the recipient of a prize and required him to designate, at the time of entry in the contest, a recipient under the age of seventeen years. Although the taxpayer had designated his seven-year-old daughter as the recipient, the Commissioner determined that the taxpayer was properly taxable for the prize. The court, holding for the taxpayer, stated:

> Certainly, it was Paul's efforts that generated the income, to whomever it is to be attributed. However, as we have found, he could not under any circumstances whatsoever receive the income so generated, himself. He had no right to either its receipt or its enjoyment. He could only designate another individual to be the beneficiary of that right.[141]

The restriction on the taxpayer's right to receive the income clearly was consensual and not legal. In so finding, the court further stated:

137. *See* Harrison v. Schaffner, 312 U.S. 579 (1941); Helvering v. Horst, 311 U.S. 112 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

138. 247 F.2d 864 (6th Cir. 1957).

139. *Id.* at 872-74.

140. 38 T.C. 1003 (1962).

141. *Id.* at 1006.

> In his ruling [Revenue Ruling 58-127], the [Commissioner] declared, "The basic rule in determining to whom an item of income is taxable is that income is taxable to the one who earns it." If by this statement the [Commissioner] means that income is in all events includible in the gross income of whomsoever generates or creates the income by virtue of his own effort, the [Commissioner] is wrong. If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. . . . Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.[142]

Accordingly, the doctrine of anticipatory assignment of income cannot be applied to EBT plans to make the parent-employee taxable since the employee never has any vested right to receive the benefits and since he has no control over the level of contributions to the trust. In essence, the argument is that there can be no anticipatory assignment by an employee who never had anything to assign.

Another judicial doctrine available to the Service in its attempt to tax the employee-parent for benefits paid from an EBT to his child is the "economic benefit" doctrine. This doctrine provides that the discharge by a third person of an obligation owed by a taxpayer to another results in the receipt of income by the taxpayer. The obligation discharged may be the obligation to pay federal income taxes,[143] the obligation to pay alimony pursuant to a divorce decree,[144] or the obligation of a parent to support his minor children.[145] Applying this doctrine to EBTs, the Service may claim that the contributions to the trust and the subsequent disbursements from it amount to the discharge of the parent's obligation to support and educate his children. The taxpayer's response must be that the doctrine is applicable only when the obligation discharged is legal rather than moral, that there is no legal obligation to provide a college education to one's children who have reached the age of majority,and that the doctrine thus is inapplicable to EBTs. The requirement that the obligation be legal results from the Supreme Court's holding in *Helvering v. Stuart*.[146] There the taxpayers, two brothers, created trusts for their children's support. While the Court concluded that one taxpayer, all of whose children were minors, was taxable for all income produced by the trust, the Court refused to hold the other brother taxable for all trust income on the ground that his children were not minors. Although disbursements from the

142. *Id.* at 1007.
143. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).
144. Douglas v. Willcuts, 296 U.S. 1 (1935).
145. Helvering v. Stuart, 317 U.S. 154 (1942).
146. *Id.*

trust satisfied the normal parental desire to make gifts to one's children, they did not discharge a legal obligation of the second brother.[147] Additional support for this distinction is found in *Brooke v. United States*,[148] in which a taxpayer who had made an absolute transfer to his children of his office building and who had used the rents therefrom to provide educational, insurance, and health benefits for the children was held not to be taxable for such income on the ground that the expenditures were not legal obligations of the parent under local law. Whether there is a legal obligation to provide a college education for one's children is a matter of state law, but no such legal obligation exists in every circumstance, especially when the child has attained the age of majority.[149]

When no obligation imposed by law is discharged, and the economic benefit can be explained by a parent's general happiness in seeing his or her child prosper, the denial of an attempt by the Service to tax the parent instead of the child is usually predicated upon, and referred to by the courts as, "familial satisfaction." The cases dealing with familial satisfaction suggest that if an item of gross income is that of an infant child, it is to be taxed to that infant notwithstanding the fact that the parent devoted his efforts, without compensation, to making the item of income available to his child.[150] The underlying policy is that the mere existence of a family relationship among taxpayers does not necessitate the taxation of all family income to the parent.[151] Thus, in cases in which a parent made gifts of income producing property to his children and aided in managing the property, the Service was not allowed to tax the parent for the resulting income since there were no indications that the gifts were devices to evade income taxes.[152] Nor is the result

147. *Id.* at 167-68.

148. 468 F.2d 1155 (9th Cir. 1972).

149. As to the amount and kind of education that should be considered necessary, the courts have never laid down a hard-and-fast rule. . . . Determination as to whether a parent should be so required [to provide a college education] in a particular case will depend on such factors as the financial condition of the parent, the ability and capacity of the child, whether the child is close to or past the statutory age of majority, whether the child is self-sustaining, and whether the parent has agreed to provide such education. . . .

59 AM. JUR. 2d *Parent and Child* § 58 (1971); *accord*, 67 C.J.S. *Parent and Child* § 15 (1950).

150. Visintainer v. Commissioner, 187 F.2d 519 (10th Cir. 1951).

151. *Cf.* Hoeper v. Tax Comm'n, 284 U.S. 206 (1931) (holding violative of due process and equal protection a Wisconsin tax statute which authorized an assessment against a husband of a tax computed on the combined total of his and his wife's income).

152. *See* Alexander v. Commissioner, 194 F.2d 921 (5th Cir. 1952); Alexander v. Commissioner, 190 F.2d 753 (5th Cir. 1951) (cattle given to infant son); Visintainer v. Commissioner, 187 F.2d 519 (10th Cir. 1951) (sheep given to four minor children).

different when the parent establishes a trust for the support of his children instead of making an outright gift. In *Helvering v. Stuart*,[153] discussed above, the trust agreement authorized discretionary distributions to the beneficiaries or application of trust income to their education, support, and maintenance until the children reached the age of twenty-five years. In holding that the taxpayer-grantor was not taxable for the trust income, the Court stated that the parent could not be taxed on the distributions merely because they would be used for the economic advantage of the children and therefore would satisfy the normal desire of a parent to make gifts to his children.[154] Thus, under the familial satisfaction rationale, disbursements from educational benefit trusts are not taxable to the parent merely because such payments serve to provide educational benefits to the child that the parent, although not legally obligated to provide, normally would desire the child to receive.

A final judicial doctrine that might be raised by the Service in an attempt to impose the tax liability on the parent-employee resulting from payments from an EBT is the doctrine of constructive dividend. This doctrine normally is applied to deny corporate deductions for amounts paid to shareholder-employees in the guise of "compensation" when such disbursements actually represent a distribution of corporate earnings,[155] but it also may be applicable whenever corporate earnings are used to discharge an obligation of or to bestow a benefit on a shareholder.[156] Factors that the courts consider in deciding whether the doctrine should be applied to a given situation include whether "compensation" and "bonuses" paid to shareholder-employees conform to some standard other than share ownership, whether and how frequently dividends are paid, the effective rate of taxation of corporate income through the years, and the degree to which corporate records substantiate the compensation, dividend, and tax policy claimed by the corporation.[157] The

153. 317 U.S. 154 (1942).

154. *Id.* at 167-68. *See also* Kohnstamm v. Pedrick, 153 F.2d 506 (2d Cir. 1945), in which the court, in upholding the taxpayer's position regarding taxation of a family trust, stated, "[a]s we understand it, it is only when a parent severs the income and retains the principal that the 'satisfaction' of his familial 'desires' becomes the equivalent of income." 153 F.2d at 508.

155. *See* Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct. Cl. 1970); Nor-Cal Adjusters, 30 CCH Tax Ct. Mem. 837 (1971); Barton-Gillet Co., 29 CCH Tax Ct. Mem. 679 (1970), *aff'd per curiam*, 442 F.2d 1343 (4th Cir. 1971).

156. *See, e.g.*, Sullivan v. United States, 363 F.2d 724 (8th Cir. 1966) (discharge of obligation to purchase employee's stock); Shepard v. Commissioner, 340 F.2d 27 (6th Cir. 1965) (forgiveness of indebtedness owed corporation by controlling shareholder).

157. *See* Crabtree, *Shareholder-Employee Compensation in the Professional Corpora-*

applicability of the constructive dividend doctrine to a well-designed educational benefit trust is doubtful. Contributions to the fund are determined by reference to expected costs of education and are in no way related to stock ownership. The plan covers all "key" employees and does not discriminate in favor of shareholder-employees. Furthermore, no cash dividend or bonus is available in lieu of the EBT plans to shareholder-employees who are childless or otherwise uninterested in educational benefits. Under these conditions, the constructive dividend doctrine appears to be entirely inapplicable.

Thus distributions from an EBT are taxable to the child-beneficiary, not the parent-employee. The parent is not required to include the payments in his gross income under sections 402 and 83 since the payments cannot be characterized as compensation.[158] None of the various judicial doctrines requires the parent to be taxed on disbursement of trust benefits.[159] Therefore, the child is required to report the payments as gross income under the general rule of section 451.[160]

IV. A Suggested Model Educational Benefit Trust Plan

The design of an educational benefit trust plan will have substantial impact on the outcome of a challenge by the Service. Such plans must be drawn carefully to give credence to the claims that the benefits derived from them are not in the nature of compensation to the employees, that rights in the trust do not vest prior to the actual disbursement of benefits, that contributions thereto represent ordinary and necessary business expenses, and that payments therefrom do not constitute constructive dividends.

To prepare a credible, factual record for purposes of possible litigation, the corporate resolution adopting the plan should state that although the corporation's employees are adequately compensated for their services by their present salaries, bonuses, and other compensatory arrangements, the corporation feels that adoption of a scholarship program is necessary to enhance employee goodwill, morale, loyalty, and faithfulness, to prevent the loss of valuable employees to competitors, and to enhance the corporation's reputation in the community by promoting education. The resolution

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tion: Present and Deferred Compensation Arrangements, 5 Seton Hall L. Rev. 173 (1974).

158. *See* notes 108-14 *supra* and accompanying text.

159. *See* notes 116-57 *supra* and accompanying text.

160. *See* note 115 *supra* and accompanying text.

should provide for a written plan establishing eligibility, funding, benefits receivable, and conditions of forfeiture under the EBT. In addition, independent trustees should be specifically required to administer the trust. The facts that no additional services by the employees or their children are required, that no particular educational institution must be attended, and that no certain course of study must be followed in order to receive benefits from the trust should be stated expressly in the resolution.

The plan should cover employees of the corporation who are of particular value or whose loss would be exceptionally harmful to the employer. Criteria for eligibility to participate in the plan should not be limited to salary levels, stockholdings, membership on the board of directors, or tenure. Furthermore, it should be clearly stated that an employee cannot receive additional compensation or other fringe benefits in lieu of participating in the EBT. The plan should prevent any possibility of rights in the trust vesting in a beneficiary prior to the actual disbursement of benefits by the use of substantial forfeiture conditions. Such conditions could include the termination of the parent-employee's employment for reasons other than death or total disability, or the rendition of services to a competitor of the employer. Additional conditions of forfeiture necessarily would include the failure of a beneficiary to incur actual educational expenses, and the failure of a beneficiary to become a candidate for a degree of an accredited educational institution before a specified age, with an extension available when the delay is due to military service. The plan should be designed to insure that contributions to the trust can never revert to the employer and that rights in the funds can never be obtained by an employee, by providing that any interest in the trust forfeited by a beneficiary will be distributed pro rata among the other beneficiaries' accounts with a gift over to a tax-exempt, charitable organization, such as a university, in the event that any unused funds remain at the termination of the plan.

The method of funding the EBT is crucial. The amount contributed should be determined soley with regard to the estimated cost of providing a certain level of education at the time the beneficiaries become eligible to receive benefits from the fund. The trustee should maintain separate accounts for each child and distribute pro rata accumulated income and forfeited funds among these accounts. The Service's revenue ruling regarding EBTs indicates that if the amounts of contributions are determined on the basis of the employee's salary, tenure, and number of hours of services rendered, instead of on the basis of merit, need, and motivation, the Service will have a stronger argument that the contributions represent compensation and not noncompensatory fringe benefits.[161] The court's analysis of section 404(a) in *Latrobe Steel* suggests the importance of avoiding funding that is related to the level of the employer's profits or that appears to be intended to satisfy the retirement needs of the employee.[162] In no event should funding bear any relation to the quality or quantity of services rendered by the employees or their ownership of stock in the corporation, nor should any adjustment of salaries or granting of additional deferred compensation to employees on the basis of the number of children in their family be made.[163]

V. Responsibility of the Attorney in Recommending an EBT

This Note indicates clearly that the likelihood of the court's upholding the tax advantages claimed to be available under EBTs is far from certain. More than an "element of risk" is involved in recommending that a client adopt an educational benefit trust, but does this require an attorney to avoid such arrangements? On the other hand, does an attorney owe an obligation to the legal process and to society to challenge the Service whenever it, in his opinion, has taken a position more favorable to the Treasury than intended by Congress in enacting the legislation underlying the matter in controversy? While there is no definite answer to these questions, some discussion of the subject is appropriate.

Disciplinary Rule 7-102 of the Code of Professional Responsibility, in part, provides:

161. Rev. Rul. 75-448, 1975 Int. Rev. Bull. No. 42.

162. 62 T.C. 456 (1974). *See* text accompanying note 69 *supra*.

163. An alternative to the educational benefit trust plan described above is the establishment by the employer of a foundation, organized and operated exclusively for the purpose of granting scholarships to selected children of employees. The advantages of such a plan are significant, altbough definite disadvantages and limitations are also present. The basic scheme envisions structuring the foundation in such a manner that it qualifies to receive deductible, cbaritable contributions under § 170 and to be exempt from taxation under § 501(a). Disbursements from the foundation should be tax-free scholarships to recipients under § 117 and should avoid characterization as taxable expenditures under § 4945. If all conditions and requirements of these sections are satisfied, such a plan would assure the employer an immediate deduction in the year of contribution, would avoid any taxes on trust income or disbursements, and would allow the beneficiaries to receive the scholarsbips tax-free. The drawbacks of such an arrangement result largely from the additional costs of satisfying the requirements of these sections. For a general discussion of company foundations, see Geske, *Scholarships for Dependents of Company Employees: Tax Problems of Company Foundations*, 51 Taxes 21 (1973).

. . . . In his representation of a client, a lawyer shall not:
(2) Knowingly advance a claim or defense that is unwarranted under existing law, except that he may advocate sucb claim or defense if it can be supported by good faith argument for an extension, modification, or reversal of existing law.[164]

Thus while a lawyer is not justified in asserting a frivolous position in litigation, he may as an advocate urge any persissible construction of the law favorable to his client without regard to personal opinion whether that construction is likely to prevail. But when the attorney is serving as an adviser and not an advocate in litigation, does the attorney owe an obligation to "play it safe" and avoid controversial recommendations? Is this obligation more certain when, as is the case with EBTs, the Service has announced its hostility to an arrangement that the attorney is considering in counseling his client? The answer to these questions is no. The attorney does owe an obligation to inform fully his client of the attendant risks involved in any transaction he recommends, but the final decision whether to adopt a particular recommendation must lie with the client.[165]

This question of the moral limitations on tax planning and recommendations is little more than the age-old problem of drawing the line between the legal and natural desire of persons to "avoid" taxation and the legally prohibited and morally reprehensible efforts of persons to "evade" taxation. Attempts to minimize one's tax liability by permissible means is clearly within the contemplation of the law as evidenced by Judge Learned Hand's comment that:

> Everyhody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.[166]

The exact location of that line is difficult to determine, and it often can be discovered only through the adversary system. There is no reason to assume that the Service is better equipped to make this determination, or is justified in its determination in every case. When reasonable, good faith arguments exist for each side of a controversy, no reason exists for an attorney not to recommend the position or interpretation most favorable to his client and thereby place the final decision in the hands of the judiciary if the client is

164. ABA Code of Professional Responsibility Disciplinary Rule 7-102-(A)(2) (1974).
165. ABA Code of Professional Responsibility, Ethical Considerations 7-7 & 7-8.
166. Commissioner v. Newman, 159 F.2d 848, 851 (2d Cir. 1947).

willing to assume the risks and expense inherent in litigation.[167]

An additional ground for upholding the propriety of an attorney's recommendation of the use of EBTs is that tax lawyers owe a duty to society in general to "take up the fight" against the Service in cases in which it has adopted a position inconsistent with the intent of Congress in enacting given legislation.[168] This conclusion is premised on the idea that the Service, and not Congress, becomes the maker of tax law if the Service is allowed to go unchallenged whenever it declares a restrictive interpretation of a statute or judicial opinion. Certainly this assertion has some validity, but attorneys must always keep in mind that they represent individuals, each having individual needs, desires, and fears. These clients' interests cannot be forsaken in the name of the great battle against the Commissioner.

Nevertheless, when a favorable interpretation of the law is supportable by good faith arguments, when the client is informed of all benefits and risks flowing from the adoption of such an interpretation, and when the client is allowed to make the final decision whether to adopt the plan generated by such an interpretation, the tax attorney is morally justified in making the recommendation and would be shirking his duty to the client if such a recommendation was not made.

VI. CONCLUSION

At the time of this writing no court has decided the tax consequences resulting from the use of the educational benefit trust arrangement. In view of the growing use of EBTs, especially by professional corporations, and the Service's announced intention to chal-

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167. This same conclusion was reached by a noted tax practitioner, who, in discussing the lawyer as an adviser in a tax matter similar to the EBT, stated:

> . . . I feel that I am justified in recommending to a client that he transfer some of his property to a trust for the benefit of members of his family with the object of minimizing the family tax burden. The client may express a natural desire to retain as much control over the property as he can without sacrifice of the objective of shifting the tax on the income from the transferred property. As I see it, my task is to help the client without letting him venture any further than necessary into unsafe territory. In doing so, I will feel no moral qualms. The problem does not involve ethical issues. My client's objective is legitimate. I often resolve some legal doubts in favor of the Government so that the client has a reasonable margin of safety. This too is my duty, but I would be derelict in the performance of my responsibility if I failed, because of moral scruples or because of disagreement with the policy of the statute, to guide the client as far as he can safely go in the direction of his desire.

Paul, *The Lawyer As a Tax Advisor*, 25 ROCKY MT. L. REV. 412, 419-20 (1953).

168. *See* Teschner, *supra* note 17 at 353-54.

lenge these plans, such a judicial ruling is likely to be forthcoming in the near future. Although the position of the Service does have some merits, taxpayers may very well emerge triumphant.

Despite the multitude of tax statutes, judicial opinions, regulations, and rulings involved in a thorough analysis of the EBT, the only true question involved is whether the taxpayer can convince the court that the benefits flowing to the taxpayer from the employer's contributions to an EBT are properly characterized as fringe benefits rather than compensation. Working against the taxpayer is the appearance of the educational benefit trust as a contrivance designed to obtain too-good-to-be-true results by the careful avoidance of every statutory and judicial basis for denying favorable tax treatment. How sympathetic can taxpayers expect courts to be to the argument that corporate executives need governmental subsidization of their children's college education in the form of preferential taxation? Courts have, however, allowed favorable tax treatment on policy grounds to plans providing educational, cultural, or medical benefits to employees or their dependents.[169] Moreover, the goal of providing educational benefits is at least as worthy of favorable tax treatment as the extended vacation plan held not to be compensation in *Latrobe Steel Co.*[170] Congress clearly has opted in favor of encouraging such desirable activities through preferential taxation and against a broader tax base. When the policy argument for striking EBTs is withdrawn from the Commissioner's arsenal of weapons, the Service is left with few substantive arguments supporting its position. The distinction between compensation and fringe benefits frequently has been recognized by the courts as well as by the Service. Deduction of business expenditures by an employer prior to the year in which such amounts are included in the employee's gross income is not without precedent. The terms of an EBT place substantial restrictions on the receipt of income by the beneficiary; to disregard such trusts on the ground that the result of their recognition is the loss of federal revenue is a dangerous policy. Although the EBT may well produce results not anticipated by Congress in enacting sections 404(a), 83, and 402, these results appear to be consistent with relevant statutory and case law and sound public policy.

As a final note, whatever the outcome of EBT litigation, the courts should take this opportunity to lay to rest once and for all

169. *See* cases cited in note 55 *supra*.

170. 62 T.C. 456 (1974); *see* notes 71-74 *supra* and accompanying text.

the Service's so-called "generation theory." The doctrine is directly opposed to the high regard traditionally given arm's-length bargaining. The inevitable result of the adoption of this theory would be to apply the least favorable tax treatment to every transaction between even unrelated taxpayers. The Code recognizes that although similar transactions should be taxed under identical rules, there are unusual transactions that, for policy reasons, should be given preferential treatment. The generation theory would abolish these policy distinctions and would lump all transactions together in a manner designed always to produce the most favorable results for the Treasury. Such a radical change in national policy must come from Congress and not the judiciary.

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