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FEDERAL INCOME TAXATION OF EDUCATIONAL BENEFIT TRUSTS

I. Introduction

A. Background

An Educational Benefit Trust (EBT) is a corporate funded employee benefit plan designed to pay the college expenses of qualified employees' children. Aside from the obvious economic benefits which result from these plans, they arguably provide several potential federal income tax advantages to both the corporation and participating employees:¹ (1) a deduction for the contributing corporation in the year of the contribution; (2) deferral of taxation on the income by the beneficiaries until the actual distribution of the trust corpus; and (3) a recognition of the taxable income to the child recipient rather than the employee parent.

To determine the corporate deductibility of contributions to EBT's requires an analysis of three issues: (1) whether the contributions constitute a deductible business expense under § 162(a) of the Internal Revenue Code; (2) whether these expenses are compensatory in nature; and (3) if these expenses are compensatory, whether an EBT constitutes a deferred compensation plan under § 404(a) of the Internal Revenue Code. The deductibility of the contributions is necessary in order for the EBT to present the corporation with any tax advantage. The determination of the compensatory nature of the contributions is important as a prerequisite to the consideration of § 404(a); clearly if the contributions are not compensation, their payment cannot constitute a deferred compensation plan. Issue (3) involves, primarily, a discussion of the Tax Court's decision in *Latrobe Steel Co.*,² in which the court defined the applicable scope of § 404(a). If EBT's are construed as § 404(a) plans, the corporation may not deduct contributions until actual distribution from the trust. However, if the contribution does not constitute compensation within the scope of § 404(a), the corporation obtains a current deduction. The Internal Revenue Service maintains the deferred deduction position in its recent Revenue Ruling on the tax consequences of an EBT.³

Alternatively, contributions to an EBT may arguably be construed as dividends, allowing the corporation no deduction for contributions to the plan. The constructive dividend position is tenable if the contributions constitute either excessive compensation or a corporate expenditure for the personal benefit of a shareholder. A finding of excessive compensation is less onerous than a finding of personal benefit, because only the excess portion of compensation would constitute the dividend. If the contribution, however, is found to have been incurred primarily for the personal benefit of a shareholder, the entire amount will be construed as a dividend and the corporation will be denied the entire deduction.

1 Henkel & Hackett, *An Analysis of Educational Benefit Trusts: How They Work, the Advantages, the Problems*, 42 J. OF TAX. 346 (1975).

2 *Latrobe Steel Co.*, 62 T.C. 456 (1974).

3 Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 6.

In addition to the issues relating to corporate deductibility, there are two major questions involving the taxability of the benefit provided by the trust. The first question concerns the timing of the income taxation. If the contributions constitute compensation, there are two possible solutions: (1) at the time the distribution is made, pursuant to § 451; or (2), as provided in § 402(b), at some time prior to distribution to the extent that the beneficiary's interest in the contribution has vested. The second major question is determining the tax liability for the trust benefit: Does the qualified employee or the child beneficiary bear the burden? Under the economic benefit theory, tax liability typically falls on the party who actually economically benefits from the income; it does not necessarily fall on the party who is apparently in receipt of the income.

The resolution of these issues should provide the practitioner an aid in determining the usefulness of an EBT to his corporate clients.

B. *EBT Models*

Before discussing these issues, it is necessary to consider the form and operation of two typical EBT instruments. An understanding of these instruments facilitates an understanding of the analysis which follows.

1. Model No. 1

X Corporation initiates a trust arrangement under which it makes predetermined annual contributions. The trust is created to provide funds for educational and related expenses incurred by children of "key"⁴ employees in attaining college or postgraduate degrees. The instrument defines a "key" employee as any employee who has worked continuously for X Corporation for a period of five or more years immediately prior to his inclusion in the plan, and has attained a salary level in excess of \$18,000 per year. X Corporation is of moderate size with several employees who presently meet the requirements of the "key" designation, and the number of such employees is likely to increase.

The corporate contributions are held by an independent trustee who maintains individual accounts for each potentially eligible child. When funds are transferred to the trustee, all corporate interest is relinquished. Income earned by the trust is distributed to each account on a pro rata basis, and extra funds resulting from a forfeited account are also distributed pro rata. Should the trust terminate for any reason, the funds are distributed to participating children meeting the requirements at that time; the remainder of the trust is then distributed to XYZ College, a tax-exempt organization.

There is no limit on the number of children from any one family who may participate in the plan. A potentially eligible child may forfeit his account for

⁴ By limiting the eligible employees to only "key" employees, the trust is effectively removed from the advantages which arise under a qualified trust. INT. REV. CODE OF 1954, § 401(a). The Regulations provide that "in order to qualify under section 401(a), a trust must . . . also be part of a plan under which there is no discrimination in contributions or benefits in favor of officers, shareholders, . . . or highly compensated employees as against other employees. . . ." Treas. Reg. § 1.401-4(a)(1)(i) (1963).

any of the following reasons: (1) the termination of the parent's employment with X Corporation;⁵ (2) the failure of the participating child to become a candidate for a degree at a college or university by a prescribed age;⁶ and (3) the failure of the participating child to incur any expenses while attending school.⁷

2. Model No. 2

This Model is substantially similar to Model No. 1, with the following differences: (1) the employer corporation, Y, is a small professional corporation with no significant planned personnel expansion, particularly in the upper levels; and (2) only two employees qualify as "key" employees under the terms of the trust, and they are the sole shareholders of the corporation.

II. Deductibility of Corporate Contributions

A. Ordinary and Necessary Expenses

Generally, an expense is deductible from gross income only if it meets the requirements of § 162(a) of the Internal Revenue Code.⁸ This section allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year"⁹ In addition, such expenses must be proximately related to the corporation's trade or business and must be reasonable in amount.¹⁰

Considerable litigation has developed over the meanings of "ordinary" and "necessary" as used in § 162(a). Although it is essentially a question of fact whether a specific expense satisfies the "ordinary and necessary" requirements,¹¹ judicial guidelines have been formed. "Necessary" has been interpreted to mean appropriate and helpful to the corporation in conducting its business.¹² Thus, a necessary expense need not be indispensable to be deductible.¹³ An

5 A variation in the plan may allow for payments to the child, upon meeting the other requirements, when the employee parent is no longer with the corporation due to death or disability. In such cases, the final distributions are usually proportional to the amount actually contributed by the corporation during the employee parent's employment. In addition, the trust might provide for the funds to "follow" the employee parent should he transfer to a corporation offering a similar benefit and which empowers its trustee to accept such transfers. Henkel & Hackett, *supra* note 1, at 347.

6 Usually, a degree at either the college or graduate school level suffices. The well-drafted trust should provide for common time extensions such as military service or service in the Peace Corps. See Henkel & Hackett, *supra* note 1, at 346.

7 Under this provision, there will be no distribution of benefits if the participating child is able, for any reason, to attend college without expense. Where expenses are reduced by partial scholarships, benefits of the plan are proportionately reduced. *Id.*

8 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

INT. REV. CODE OF 1954, § 162(a).

9 *Id.*

10 Treas. Reg. § 1.162-1(a) (1975) (proximately related); Commissioner v. Lincoln Elec. Co., 176 F.2d 815 (6th Cir. 1949).

11 Welch v. Helvering, 290 U.S. 111, 113 (1933).

12 *Id. Accord*, Cubbedge Snow, 31 T.C. 585, 591 (1958); Bennett's Travel Bureau, Inc., 29 T.C. 350, 358 (1957).

13 31 T.C. at 591; B. Manischewitz Co., 10 T.C. 1139, 1145 (1948).

"ordinary" expense, on the other hand, is an expense common to the type of business in which the taxpayer is engaged.¹⁴ Therefore, it is not required that the expense be habitual or normal in the sense that it is frequently or regularly made by the same corporate taxpayer.¹⁵ Additionally, there is no requirement that the expense be made pursuant to a legal obligation.¹⁶ The corporate contributions involved in EBT's are appropriate and helpful, and therefore necessary, because they promote good employer-employee relations;¹⁷ and the current, frequent business use of employee-benefit plans as integral components of a compensation package dictates that contributions to EBT's are also ordinary.¹⁸

As previously indicated, § 162(a) requires that the expense be proximately related to the business operation. A contribution to an employee benefit plan satisfies this requirement if it bears a direct relation to a consequent benefit to the corporation.¹⁹ This requirement has been liberally interpreted by the courts, and it has generally been held that since contributions to employee benefit plans "reasonably tend to the gratification, good will and loyalty of employees,"²⁰ and thereby benefit the corporation, they constitute a deductible expense. A common illustration is a contribution to provide medical facilities for employees. These plans have long been found to directly benefit a corporation through the "esprit de corps"²¹ they produce. The same rationale is applicable to contributions to EBT's since they also provide a benefit to the corporation in the form of employee contentment.

Assuming they are reasonable in amount, it is clear that contributions to EBT's satisfy the requirements of § 162(a) and are thus deductible. The timing of the deduction, however, is not so clear. Section 162(a) provides for a deduction in the year the corporation makes the contribution.²² However, Treasury Regulation § 1.162-10(a) states that amounts contributed to employee benefit plans are not deductible in the year contributed if those contributions provide deferred compensation.²³ Before ascertaining whether contributions to EBT's constitute a deferred compensation plan, it is essential to determine whether the contributions to the EBT are compensatory in nature.

B. Compensation

Treasury Regulation § 1.162-10(a) dictates that contributions to non-compensatory employee benefit plans when not used to provide benefits in conjunction with a deferred compensation plan are deductible in the year contrib-

14 *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940).

15 290 U.S. at 114.

16 *Champion Spark Plug Co.*, 30 T.C. 295, 298 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959); *Waring Prods. Corp.*, 27 T.C. 921, 929 (1957).

17 *See American Factors, Ltd. v. Kanne*, 76 F. Supp. 133, 136 (D. Hawaii 1948), *rev'd on other grounds*, 190 F.2d 155 (9th Cir. 1951); 4 *WASHBURN L.J.* 157, 159 (1964).

18 *See Deputy v. Du Pont*, 308 U.S. 488 (1940).

19 *Kavai Terminal, Ltd.*, 36 B.T.A. 893, 896 (1937); *Adam, Meldrum & Anderson Co.*, 29 B.T.A. 419, 424 (1933); *Sugarland Indus.*, 15 B.T.A. 1265, 1269 (1929).

20 76 F. Supp. at 136.

21 15 B.T.A. at 1269.

22 INT. REV. CODE OF 1954, § 162(a).

23 *Treas. Reg. § 1.162-10(a)* (1958).

uted.²⁴ In evaluating the nature of any corporate payment for § 1.162-10(a) purposes, the intent of the contributing corporation making the payment is relevant,²⁵ and intent in these cases is purely a question of fact.²⁶

Some commentators argue that while contributions to an EBT are valid expenses under § 162(a), they are not intended as compensation. Indeed, it is said that their purpose is to "promote and improve employee loyalty, goodwill, efficiency and morale."²⁷ Often the circumstances underlying the EBT will establish whether the required compensatory intent actually exists. For example, if the corporate taxpayer considered increasing the salary of a "key" employee, but instead made contributions to an EBT, there is little doubt that the underlying corporate intent was to compensate the employee. Similarly, a requirement that employees included in an EBT undergo a salary adjustment to reflect the number of their potentially eligible children indicates the compensatory intent behind the contribution.²⁸ The common element in these situations is that the benefit conferred upon the employee is dependent on the services performed by the employee. Even where the circumstances do not clearly indicate the necessary compensatory intent, it may be possible to imply such an intent from the existence of a dependency relation. In other words, where an employee receives a benefit based on the level of services he renders, the implication is that the benefit is intended as compensation.

Even those who claim that contributions to an EBT are not compensatory in nature recognize that the substance of compensation involves payments related to the quantity and quality of services performed by an employee.²⁹ Whether EBT contributions are in fact related to services is undecided. A "key" employee must meet a prescribed quantitative and qualitative measure of work.³⁰ The quantitative measure is the prior length of service requirement and the continued employment requirement seen in Model No. 1. The relation between the benefit and the quality of services is evidenced by the salary level requirement of Model No. 1. Unless a certain minimum level of service is achieved, determined by the amount of salary paid, the benefit does not flow to the employee. A more typical situation that illustrates this relation between level of services and compensation is the bonus awarded salesmen on achieving certain quotas. Normally, the bonus figure is directly related to a specific level of performance. This proportional dependence between payment and performance reflects compensatory intent. Similarly, the establishment of this relation

24 *Id.* This section states that contributions to employee benefit plans are deductible under § 162(a) unless they provide benefits under a § 404(a) deferred compensation plan.

25 See Schwartzman, *Executive Fringes: A Look at Some New and/or Exotic Benefits*, N.Y.U. 32D INST. ON FED. TAX. 925 (1974); *Peters v. Smith*, 221 F.2d 721 (3d Cir. 1955).

26 *Commissioner v. Duberstein*, 363 U.S. 278, 289 (1960); *Bogardus v. Commissioner*, 302 U.S. 34, 43 (1937).

27 *Henkel & Hackett*, *supra* note 1, at 348.

28 *Id.* at 349.

29 In supporting their claim that EBT contributions are not compensation, some commentators argue that they are unrelated to the quantity or quality of services rendered. The implication of this argument is that the existence of such a relation is the substance of compensation. *Id.* at 348.

30 These qualifications are required under the Model plans described in text accompanying notes 4-7 *supra*.

supports the conclusion that the corporate contribution to an EBT is compensation.

In Revenue Ruling 75-448,³¹ the Internal Revenue Service also concluded that contributions to EBT's are made with compensatory intent. The Service stated:

The 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.³²

Apparently, then, the Service also relied on this dependency relation between the benefit (EBT contributions) and the services rendered in establishing the corporation's intent to compensate. Since contributions to the EBT are compensation, it is necessary to determine whether the method of contribution constitutes a deferred compensation plan within the meaning of § 404(a) in order to fix the timing of the deduction.

C. § 404(a): *Before and After Latrobe Steel*

As indicated previously, the general rule is that compensation paid by an employer is deductible from corporate income in the year it is paid.³³ Section 404(a), however, provides an exception; payments to a stock bonus, pension, profit-sharing, or annuity plan or compensation "paid or accrued on account of any employee under a plan deferring the receipt of such compensation,"³⁴ are specifically excluded from the current deduction provision in § 162(a),³⁵ and are included under the less advantageous provisions of § 404(a). Prior to *Latrobe*, this section was interpreted as including every plan which had the effect of deferring compensation.

1. *Seven-Up Bottling*

The Tax Court broadly defined the applicable scope of § 404(a) in *New York Seven-Up Bottling Co.*³⁶ The court considered a severance pay benefit trust, under the terms of which benefits were paid to employees upon termination of their employment with the Seven-Up Company. The trust further provided

31 Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 6. The facts of this ruling indicate a plan similar to that in Model No. 1. See text accompanying notes 4-7 *supra*.

32 *Id.*

33 Treas. Reg. § 1.162-10(a) (1958).

34 *Id.*

35 Section 404(a) provides the following special deduction rules: (a) qualified pension trusts in the taxable year when paid, in the amount not in excess of five percent of the total compensation paid or accrued to employees under the trust; (b) qualified annuities are deducted in accordance with (a); (c) qualified stock bonus and profit sharing in the taxable year when paid in an amount not in excess of 15 percent of compensation otherwise paid to employees under the plan; and (d) other plans in the year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan. INT. REV. CODE OF 1954, § 404(a).

36 50 T.C. 391 (1968).

that if the accrued benefits were not utilized by the employer, a lump sum payment would be made to the employee at his retirement or to his estate at his death. In concluding that the trust constituted a deferred compensation plan, the court held that § 404(a) was not limited strictly to the four types of plans listed in the section (stock bonus, pension, profit-sharing, or annuity), but applied to all plans which had the effect of deferring the receipt of compensation.³⁷ This decision was relied upon by a federal district court in *Lundy Packing Co. v. United States*.³⁸ A sick-pay plan, which guaranteed unused funds to the employees upon termination or their estates at death, was also considered within the confines of § 404(a), despite its apparent dissimilarity to any of the four enumerated plans.

2. "Similar Test"

Six years after the *New York Seven-Up* decision, however, the Tax Court in *Latrobe Steel Co.* significantly modified its holding. While *New York Seven-Up* applied § 404(a) to any plan which deferred compensation, the ruling in *Latrobe* severely limited the section's application under a newly created "similar" test. In 1963, the taxpayer, Latrobe, entered into a labor agreement with the United Steelworkers of America which, as later amended, provided for an extended vacation plan to supplement the regular vacation plan. The agreement provided that any employee with one or more years of continuous service would be eligible for a regular vacation ranging from one to four weeks, depending on his length of service. To facilitate expanded employment, the agreement further provided an extended vacation plan for qualifying employees, allowing not less than seven but not more than 13 weeks of consecutive time off.³⁹ After an employee's right to the vacation vested, he became eligible for the extended benefits once every five years. And the plan provided that upon death, the vacation pay then due an employee would be paid to his wife or his estate.

The Tax Court unanimously⁴⁰ held that the trust arrangement was beyond the meaning of deferred compensation plans under § 404(a), and therefore allowed the corporation to deduct its contribution in the year paid. The court relied on the congressional intent underlying § 404(a); § 404(a) has special rules governing the deductibility of corporate contributions to qualified stock bonus, pension, profit-sharing, and annuity plans, and "other" plans. Since the trust was not one of these enumerated plans, the court was forced to consider the scope of "other" plans.

Seeking guidance in the area, the court noted that § 23(p) of the Internal Revenue Code of 1939⁴¹ was identical to § 404(a) and, therefore, considered

37 50 T.C. at 398.

38 302 F. Supp. 182 (E.D.N.C. 1969), *aff'd*, 421 F.2d 850 (4th Cir. 1970).

39 Under the extended vacation plan, at the beginning of the employee's 13 week period he is paid in full for his vacation time. Those employees who so desire may receive the 13 weeks pay, and return to work anytime after the seventh week, receiving additional pay for work done during that early return period. 62 T.C. at 459.

40 There were three judges concurring.

41 Revenue Act of 1942, ch. 502, § 162(b), 56 Stat. 863, *amending* INT. REV. CODE OF 1939, § 23(p).

the legislative history of the earlier provision to represent the congressional interpretation of "other" plans. Although a different version of § 23(p) was finally enacted, the originally proposed § 23(p) provided in part:

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 . . . be deductible . . . under this subsection.

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 was such a plan.⁴²

The court considered the phrase "similar plan" significant, and referred to congressional committee reports in an attempt to properly interpret the scope of that phrase. The House Ways and Means Report employed the phrase "similar plan" when explaining that § 23(p) was applicable to contributions under any of the four enumerated plans, or "similar plan deferring the receipt of such compensation."⁴³ The report added that deductions would not be allowed for payments under such a similar plan until the year in which the compensation was actually paid to the employee. In both the Senate⁴⁴ and House⁴⁵ reports for § 23(p), Congress indicated that its concern with deferred compensation plans was limited to only certain types of plans. The reports noted that the purpose of § 23(p) and related sections was to specifically ensure that stock bonus, pension, profit-sharing, and annuity plans did not discriminate in favor of corporate executives. In light of this limited concern, it is clear that by using the words "similar plan" in the proposed section, Congress intended that the section was not applicable to any plan which deferred the receipt of compensation. Congress only attempted to prevent circumvention of the section by plans basically identical to the four specifically set out, but which were otherwise excepted due to minor form differences.

Accordingly, the *Latrobe* court devised the "similar test" analysis;⁴⁶ § 404(a) is thus applicable only to the four enumerated plans, or to other deferred compensation plans that have characteristics similar to the four. The Treasury Regulations under § 23(p)⁴⁷ and § 404(a)⁴⁸ provide support for this conclusion. While each states that its respective sections are not restricted to formal stock bonus, pension, profit-sharing, or annuity plans or other deferred compensation plans, they also limit the sections' application to the four or "similar plans."

For many years prior to *Latrobe*, the Tax Court viewed § 404(a) as being applicable to any deferred compensation plan. This construction was attribut-

42 H.R. 7378, 77th Cong., 2d Sess. 113-16 (1942) (emphasis added).

43 H.R. REP. NO. 2333, 1942-2 CUM. BULL. 372, 451.

44 See S. REP. NO. 1631, 1942-2 CUM. BULL. 504, 607-09.

45 See H.R. REP. NO. 2333, 1942-2 CUM. BULL. 451-52.

46 The majority opinion never formally named the standard it established, but Judge Raum, in a concurring opinion, labeled it the "similar test." 62 T.C. at 468.

47 Treas. Reg. 118, § 39.23(p)-1(c) (1948).

48 Treas. Reg. § 1.404(b)-1 (1956).

able to a literal interpretation of § 404(a), and not to an interpretation based on the section's historical purpose. Again, the final enacted version of § 23(p) differed from the section as originally introduced; the enacted version stating in part:

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 . . . be deductible under this subsection.

If there is no plan but a method of employer contributions or compensation 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 was such a plan.⁴⁹

In the first part of the enacted version, Congress substituted the phrase "under a plan deferring" for "similar plan." This later enacted version of § 23(p) is identical to § 404(a), which also makes the limited mention of "similar plan." Only § 23(p)'s legislative history provided interpretative value for the omission. The Senate Finance Committee Report stated that the change in language was motivated only by a desire to bring the language of § 23(p) into conformity with other sections of the Code and was of no interpretative significance.⁵⁰ The court, therefore, concluded that despite the absence of the words "similar plan," its understood meaning is impliedly present in the current section's references to other deferred compensation plans.⁵¹

3. Inadequate Standards

Although the *Latrobe* court properly employed the "similar" test in § 404(a), the court failed to adequately define the standards for applying the test. This prompted a concurring judge to correctly conclude that "[u]ntil such time, however, that the standards for applicability do become clear, taxpayers and their planners face an uncertain and haphazard road in planning their affairs."⁵²

The majority opinion only generally intimated what is required under the similar test. An illustration of the inadequacy of these general "standards" is found in their application as made by the *Latrobe* court to the facts of the earlier *New York Seven-Up* case. Referring to the applicable Treasury Regulations,⁵³ the court summarily defined pension and annuity plans as plans which

49 INT. REV. CODE OF 1939, § 23(p) (emphasis added).

50 S. REP. NO. 1631, 1942-2 CUM. BULL. 607.

51 Additionally, the Tax Court supported its position on this issue by pointing to the presence of the phrase "similar plan" in the second part of the section quoted in the text.

To conclude otherwise would result in the inconsistency of subjecting all formal deferred-compensation plans to the strict deduction rules of section 23(p)(1), but permitting a plan not similar to the four enumerated plans to escape those strict rules by simply transforming that plan to a method of contributions having the effect of a plan.

52 T.C. at 464.

53 62 T.C. at 469.

54 Treas. Reg. § 1.401-1(b)(1)(i) (1972) (pension plans); Treas. Reg. § 1.404(a)-3(a) (1972) (annuity plans).

supply employees with "actuarially determinable benefits upon retirement."⁵⁴ In modifying its *New York Seven-Up* decision, the Tax Court in *Latrobe* noted that the result of the prior case would not be changed by its newly restricted interpretation. The *Latrobe* court found the severance pay plan in *New York Seven-Up* was sufficiently similar to a pension plan to invoke § 404(a), even though the plan lacked the two elements—actuarially determinable benefits and distribution upon retirement—which the court had previously considered to be the substance of pension plans. The summary treatment given pension and annuity plans was similarly accorded to profit-sharing and stock bonus plans. The court concluded that these plans are merely a means through which employees can share in their employer's profits,⁵⁵ without further indicating what characteristics of these plans the court would consider necessary to a finding of similarity.

The scope of the court's standards is thus impossible to determine from the opinion, and only further litigation or congressional intervention will provide suitable guidelines. It is unlikely that the Internal Revenue Service will promulgate any helpful rulings on the issue in the near future, since it has not yet indicated what action it will take on the *Latrobe* decision. Presently, however, it is doubtful that an EBT is sufficiently similar to a stock bonus, pension, profit-sharing, or annuity plan to bring it within the confines of § 404(a). The contributions to the EBT are clearly not intended as postretirement or even post-termination benefits since, as Model No. 1 provides, any rights to these contributions are forfeited upon termination of employment.⁵⁶ Similarly, the contributions are not related in any way to the profits of the business, but rather are proportional to the amount of expenses incurred by each child.⁵⁷ Therefore, as ordinary and necessary expenses which do not constitute deferred compensation, corporate contributions to EBT's should be deductible by the corporation in the year contributed.

4. The Service's Position

This conclusion is, however, contrary to the Internal Revenue Service's findings in Rev. Rul. 75-448.⁵⁸ There the Service held that solely because the plan defers the receipt of compensation, contributions to the EBT fall within § 404(a) and are thus not deductible "until an amount attributable to the con-

⁵⁴ 62 T.C. at 464.

⁵⁵ *Id.*

⁵⁶ Treas. Reg. § 1.401-1(b)(1)(i) (1972) provides:

A pension plan . . . is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement.

Treas. Reg. § 1.404(a)-3(a) (1972) provides: "[A]n annuity plan means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust."

⁵⁷ Treas. Reg. § 1.401-1(b)(ii) provides: "A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries."

Treas. Reg. § 1.401-(b)(1)(iii) (1972) provides:

A stock bonus plan is a plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan, except that the contributions by the employer are not necessarily dependent upon profits and the benefits are distributable in stock of the employer company.

⁵⁸ Rev. Rul. 75-448, 1975 INT. REV. BULL. No. 42, at 6.

tribution is includible in the gross income" of participating employees. This position is clearly inconsistent with the Tax Court's holding in *Latrobe* and may signal the Service's intention to appeal that decision. Indeed, should the Service acquiesce in the *Latrobe* decision, the Ruling's effectiveness would be substantially diminished.

It is too early to conclude with any certainty whether the Service will succeed in its apparent attempt to reject the *Latrobe* decision and defer a corporation's deduction for its contribution to an EBT. While the deferral of the deduction poses serious tax disadvantages to the corporation which should be fully considered before employing such an arrangement, the possibility that its contribution may constitute a dividend is even more ominous.

III. Constructive Dividends

A. Background

Section 301 of the Internal Revenue Code⁵⁹ provides that a distribution of property⁶⁰ by a corporation to its shareholders is a dividend as long as the corporation has undistributed earnings and profits.⁶¹ Additionally, Treasury Regulation § 1.301-1(c)⁶² requires that the distribution be made to the shareholder in his shareholder capacity. Thus, a distribution to a shareholder is not a dividend if the distribution is made to him as a creditor rather than as a shareholder. Typically, dividends are formally declared and distributed by the corporation, with each shareholder receiving a benefit in proportion to his holdings. However, the fact that the corporation does not formally declare a dividend,⁶³ or that the distribution is to only some of the shareholders⁶⁴ and not in proportion to their holdings,⁶⁵ will not necessarily preclude a court from construing the distribution as a dividend.

Corporations often attempt to disguise distributions of earnings to shareholders as deductible business expenses. A corporation may argue that payments made to its shareholder employees are compensation for services rendered. However, if the payments are unreasonable in amount in light of the services actually rendered by the shareholder employee, a court may find the excess amount constitutes a constructive or disguised dividend. Similarly, a corporation may attempt to deduct contributions to an employee accident and health plan under § 162(a). Where the only employees to benefit under the plan are shareholders, however, a court is likely to find that the purpose of the corporate contribution

⁵⁹ INT. REV. CODE OF 1954, § 301.

⁶⁰ INT. REV. CODE OF 1954, § 317: "For purposes of this part, the term 'property' means money, securities, and any other property."

⁶¹ INT. REV. CODE OF 1954, § 316(a): "Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits."

⁶² Treas. Reg. § 1.301-1(c) (1973).

⁶³ *Biltmore Homes, Inc. v. Commissioner*, 288 F.2d 336 (4th Cir.), cert. denied, 368 U.S. 825 (1961).

⁶⁴ *Paramount-Richards Theatres, Inc. v. Commissioner*, 153 F.2d 602 (5th Cir. 1946).

⁶⁵ *Gibbs v. Tomlinson*, 362 F.2d 394 (5th Cir. 1966).

was to benefit the employees as shareholders and not as employees.⁶⁶ Should this be the case, then the contribution is again a constructive dividend and not a deductible business expense.⁶⁷

Thus, corporate characterizations of contributions are not controlling.⁶⁸ Indeed, the courts often find that the true nature of the contribution is contrary to expressed corporate intent.⁶⁹ Therefore, in applying § 301 courts generally conclude that a corporate contribution which in fact confers an "economic benefit on the stockholder without the expectation of repayment" is a constructive dividend.⁷⁰ The courts in these cases are concerned with the substance, not the form, of the benefit plan and attempt to determine the practical effect of the corporate contribution.⁷¹ In Model No. 2, then, notwithstanding the fact that the contributions are ostensibly made to benefit employees, a court may construe the contributions to the EBT as dividends.⁷²

B. *Alternate Theories*

There are two theories by which the contributions made in Model No. 2 may be viewed as constructive dividends. If the contributions constitute compensation they may be excessive in amount, the unreasonable portion constituting a dividend. Alternatively, the contribution may be viewed as a corporate payment for the personal benefit of the shareholder. Here, the entire contribution is a dividend and consequently no corporate deduction is available.

1. Excessive Compensation

Assuming that the contributions to the trust are compensatory, only the "reasonable" portion of the compensation may be deducted by the corporation.⁷³ Under this theory the tax disadvantage to the corporation is relatively moderate, since only the amount of compensation above the reasonable level is deemed a dividend.⁷⁴ Treasury Regulation § 1.162-7 (b)(1) states that when

salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees it would seem likely that . . . the excessive payments are a distribution of earnings upon the stock.⁷⁵

The corporate-shareholder relationship implies that the compensation is not wholly for services rendered, but that the excess amount represents a payment

66 See Alan B. Larkin, 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968).

67 *Id.*

68 See also *Sachs v. Commissioner*, 277 F.2d 879 (8th Cir.), *cert. denied*, 364 U.S. 833 (1960).

69 *Helvering v. Gordon*, 87 F.2d 663 (8th Cir. 1937).

70 362 F.2d at 397.

71 277 F.2d at 882; 87 F.2d at 666.

72 See 48 T.C. 629.

73 INT. REV. CODE OF 1954, § 162(a)(1) states that a deduction is allowed for "a reasonable allowance for salaries or other compensation for personal services actually rendered."

74 Treas. Reg. § 1.162-7(b)(1) (1958).

75 *Id.*

"made because of the recipient's proprietary investment in the corporation."⁷⁶ If the Internal Revenue Service considers the amount of compensation unreasonable, the burden is on the corporation to prove the reasonableness of the total compensation figure.⁷⁷ This burden is typically satisfied by showing the amount paid corresponds to services actually rendered or with the compensation levels of similarly situated employees in other corporations.⁷⁸

Should the corporation fail to meet this burden, the effect is twofold: (1) the corporation incurs an expense, without receiving a concurrent benefit, in the amount of the excess compensation; and (2) the corporation is denied a deduction for that expense. The trust arrangement, however, can be drafted to mitigate these effects of the constructive dividend finding. The trust should provide that if the corporate contributions are found by the Internal Revenue Service to be excess compensation to shareholder employees, the excess amounts must be returned to the corporation. Under § 162(a), the shareholder employee could then deduct the amount returned. A deduction pursuant to a similar repayment plan has been approved by the Service in Rev. Rul. 69-115.⁷⁹ There, salaries had been paid to the four shareholders of the corporation subject to a resolution adopted by the corporation. The resolution obligated the shareholders to return the amount of their salaries which the Service disallowed as deductible business expenses to the corporation. The Ruling held that the shareholders were entitled to a deduction for the amount returned since it was repaid under a legal obligation originating prior to the payment of the salaries. Accordingly, to be successful from the shareholder perspective, the repayment agreement must be executed prior to the actual date of the contributions to the EBT⁸⁰ and must also constitute a legal obligation enforceable against the shareholder; a repayment pursuant to a voluntary plan will not be allowed a deduction by the Service.⁸¹

By using a repayment agreement, the corporation has little to lose in attempting the disguised dividends. If the corporation successfully disguises the distribution, it receives a deduction for that portion of the contributions which is actually a dividend and the repayment agreement is not activated. However, if the excessive portion of the contribution is recognized as a dividend, the corporation's losses are minimized by the agreement. While the corporation loses a deduction equal to the excess amount, the shareholder is obligated to repay that amount; thus, the corporation's loss is limited to its inability to use that money while it is under the shareholder's control. In addition, the shareholder is given a deduction for the amount repaid, placing him in substantially the same position he would have been in had the trust contribution never been made.

76 4A J. MERTENS, *THE LAW OF FEDERAL INCOME TAXATION* § 25.64, at 293 (J. Malone ed. 1972).

77 *Roth Office Equip. Co. v. Gallagher*, 172 F.2d 452 (6th Cir. 1949).

78 See generally MERTENS, *supra* note 76, §§ 25.68-83, at 308-43.

79 Rev. Rul. 69-115, 1969-1 CUM. BULL. 50.

80 It is also in the employee's interest to provide the repayment clause at the start of the trust rather than at a later date; a later agreement may be viewed with suspicion by the Service as a means of circumventing the regulation. See Nims, *Minimizing Constructive Dividend Exposure*, TUL. 16TH TAX INST. 259 (1966).

81 Stuetzer, *Reasonable Compensation*, N.Y.U. 25TH INST. ON FED. TAX. 491, 507 (1967).

While application of the constructive dividend theory to compensation has traditionally been limited to situations in which the amount of compensation is unreasonable, a recent Court of Claims case has substantially expanded its application. *Charles McCandless Tile Service v. United States*⁸² created a new facet in this compensation dividend relation: the "automatic dividend" rule.⁸³ There, a father and son who were officers, shareholders, and employees of the corporation controlled the distribution of earnings and determined their levels of compensation. The court specifically found that the salaries paid to the shareholder employees were reasonable in view of the services performed by them, but disallowed a portion of the deduction for the salaries because no dividends were declared or distributed by the highly profitable corporation for a five year period. Some portions of the salaries paid to its shareholder employees, the court reasoned, must be a distribution of earnings. Thus, despite a compensatory scheme that is reasonable in amount, a portion of the contributions in Model No. 2 may nevertheless be dividends, and therefore nondeductible, if the corporation fails to otherwise provide formal dividends.

2. Personal Benefit

A determination that the contributions are constructive dividends is not limited to the situation in which those contributions are excess compensation for services rendered. The same result occurs when the contributions are payments for the personal benefit of a shareholder. "The crucial concept in finding a constructive dividend is that the corporation conferred an economic benefit on the stockholder without the expectation of repayment."⁸⁴

Whether a distribution is for the economic benefit of the shareholder depends on whether the corporate payment is primarily for the benefit of the corporation or for the personal benefit of the shareholders.⁸⁵ For example, a corporate payment which discharges a shareholder's legal obligation is universally recognized as a dividend.⁸⁶ However, if the same payment primarily discharges a corporate obligation, such as compensating the shareholder employee for services, and thereby incidentally benefits the shareholder, there is no dividend.⁸⁷ This theory, then, dictates that when the contributions to an EBT in fact constitute reasonable compensation, there is no dividend.⁸⁸ The contributions are primarily intended to discharge the corporation's obligation to compensate the shareholder employee for his services; from the corporation's standpoint, the benefit to the shareholder is only incidental.

It is arguable, however, that contributions in Model No. 2 do not constitute compensation and thus may be characterized as simply for the personal benefit of

82 442 F.2d 1336 (Ct. Cl. 1970).

83 See Holden, *Has Court of Claims Adopted an "Automatic Dividend" Rule in Compensation Cases?*, 32 J. OF TAX. 331 (1970).

84 362 F.2d at 397.

85 See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 7.05, at 7-27 (3d ed. 1971).

86 See, e.g., *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966).

87 See, e.g., *Joseph McReynolds*, 17 B.T.A. 331 (1929).

88 See, e.g., *Alex Silverman*, 28 T.C. 1061 (1957).

the shareholder. Admittedly, under the facts of Model Nos. 1 and 2, the amount of benefit is not totally dependent upon services rendered and thus the existence of a compensatory intent motivating the contributions might be questioned. In either model the amount of service is only initially important in that it determines who is included under the plan. When an employee has met this original requirement, his benefits increase with the number of his children participating in the plan, regardless of the amount of additional services he renders to the corporation. The courts, however, are more likely to scrutinize Model No. 2, since corporate payments to shareholder employees are particularly suspect.⁸⁹ The rationale is that expenditures which benefit only shareholders may be disguised corporate distributions not motivated by any real compensatory intent. The possibility exists that the superficial compensatory nature of the contribution might be considered a facade and thus construed as a dividend.

The conclusion that contributions to an EBT are not compensation does not necessarily render them dividends; if any legitimate corporate interest is served by the contribution, it will be allowed as a deductible business expense. However, if the contributions are not compensation, it is difficult to conclude that they serve any purpose other than the personal benefit of shareholders included in the plan. An analogous situation was presented in *Noble v. Commissioner*.⁹⁰ There the court considered a corporate reimbursement to shareholders for expenses incurred in repairing their residences. The court held that the repair expenditures were not related to any corporate business purpose but were strictly of a personal nature. Their reimbursement, therefore, constituted a dividend.⁹¹

Similarly, then, when contributions to EBT's are noncompensatory and serve no corporate business purpose, they are dividends. If, for example, the EBT obligated the receiving child to work for the company for a prescribed period following his graduation as a condition to receiving the benefit, that obligation might be viewed as a benefit to the corporation. Then, the corporate contribution might be recognized as serving a corporate interest. Model No. 2 provides no such obligation, however.

The fact that the payments are not made to the shareholder directly is of no legal significance, since the contribution is constructively received by him. This principle originated in *Old Colony Trust Co. v. Commissioner*,⁹² which held that the discharge of an employee's obligation by a corporation constituted taxable income to the employee. The Court viewed the discharge as a constructive payment to the employee who then used the amount to discharge his own obligation. Under this principle, EBT contributions would be recognized as a constructive payment to the shareholder who then makes contributions to the trust. The fairness of this conclusion is supported by the fact that the shareholder, as part owner of the corporation, is at least partly responsible for directing the corporation to bypass him in distributing its earnings and profits.

In conclusion, if a corporation attempts to avoid a confrontation with the

89 See 1 MERTENS, *supra* note 76, § 9.18, at 57.

90 368 F.2d 439 (9th Cir. 1966).

91 *Id.* at 443.

92 279 U.S. 71 (1929).

Internal Revenue Service on the issue of deferred compensation by attempting to show that the contributions were not made with a compensatory intent, it could be creating a far greater problem. Rather than incurring the disadvantages of a deferred deduction under Rev. Rul. 75-448, the corporation risks the denial of any deduction under the theory of constructive dividends.

IV. Taxing the Receipt of Income

A. *Timing*

When the contributions to an EBT will be taxed as realized income is an equally important inquiry. Whether the taxable event occurs at the time of contribution or at the time of distribution depends upon the nature of the contribution.

1. Noncompensatory Fringe Benefits

Section 451 of the Internal Revenue Code⁹³ dictates that income is generally not taxable until the year it is actually or constructively received by the taxpayer. Clearly, where the contribution to the EBT is a noncompensatory fringe benefit, there is no actual receipt of income until the trust corpus is distributed. Therefore, trust benefits must be constructively received before actual distribution to constitute taxable income prior to that time. Treasury Regulation § 1.451-2(a) states: "income is not constructively received if the taxpayers' control of its receipt is subject to substantial limitations or restrictions."⁹⁴ In addition, § 1.451-2(a) provides that income is constructively received by the taxpayer in the taxable year

during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.⁹⁵

Basically, these principles are interpreted to mean that "if all the taxpayer has to do is reach for the receipt, this will be sufficient."⁹⁶ Physical control over the income is not necessary; it is sufficient if the taxpayer can control the disposition of the income.⁹⁷

The typical EBT does not provide sufficient control of the participating child's account to satisfy the requirements of constructive receipt. At any time prior to the actual distribution, all rights in the trust are subject to substantial

93 INT. REV. CODE OF 1954, § 451: "(a) GENERAL RULE—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer."

94 Treas. Reg. § 1.451-2(a) (1971).

95 *Id.*

96 J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* § 82, at 229 (2d ed. 1973).

97 *Geiger's Estate v. Commissioner*, 352 F.2d 221 (8th Cir. 1965), *cert. denied*, 382 U.S. 1012 (1966).

risks of forfeiture. No control exists outside the trust itself. Accordingly, if the EBT is viewed as a noncompensatory fringe benefit, no tax should be assessed until distribution.⁹⁸

2. Compensation

The Tax Court decision in *Latrobe* indicates that if the contribution is deemed to be nondeferred compensation, § 451 delays the recognition of taxable income until actual or constructive receipt. More specifically, to the extent the EBT is not covered by the deferred compensation sections of the Code, the benefits emanating from the trust are taxed in accordance with § 451. However, should the courts adopt the Service's position that EBT's provide deferred compensation, § 402(b) would control the timing of the taxation. Section 402(b) of the Code⁹⁹ controls the taxability of corporate contributions to nonexempt deferred compensation trusts. Under that section, the contributions are includible in the gross income of the beneficiary when made, but only if and to the extent that the beneficiary's interest in the plan is vested.

An interest is vested if it is transferable or not subject to a substantial risk of forfeiture as defined by the Treasury Regulations under § 83.¹⁰⁰ A transferable interest is merely one capable of transfer to another individual.¹⁰¹ An interest is subject to a substantial risk of forfeiture if the beneficiary's rights to full enjoyment of his interest are conditioned on future performance, or nonperformance, of services by any individual.¹⁰² If, however, the beneficiary's interest is forfeitable at the time of contribution, the Regulations provide that such amounts are not included in gross income in the year of contribution or in the year they become nonforfeitable.¹⁰³ Instead, the amount contributed is taxable in the year distributed or made available to the beneficiary under the trust.

Therefore, even if constituting a deferred compensation plan under § 404(a), correctly drafted EBT's should provide no taxable income until the year in which college expenses are incurred by the participating child. This is accomplished by providing, as Model Nos. 1 and 2 do, conditions of forfeiture that may become effective at any time prior to the actual distribution.¹⁰⁴ For example, forfeiture can occur upon termination of the parent's employment with the corporation, or upon failure of the child to actually incur expenses.

98 It has been concluded that the contributions are compensation; *see* text accompanying notes 24-31 *supra*.

99 INT. REV. CODE OF 1954, § 402(b): "Contributions to an employees trust . . . shall be included in the gross income of the employee in accordance with section 83. . . ." INT. REV. CODE OF 1954, § 83(a):

[such property] shall be included in the gross income of the person who performed the services 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, whichever is applicable.

100 Treas. Reg. § 1.402(b)-1(a)(1) (1966).

101 Proposed Treas. Reg. § 1.83-3(d) (1971).

102 Proposed Treas. Reg. § 1.83-3(c) (1971).

103 Treas. Reg. § 1.402(b)-1(a)(1) (1966).

104 See the conditions of forfeiture detailed in Model No. 1, *supra*.

3. Dividends

If the EBT benefit is construed as a dividend, tax liability should be assessed at the time of the corporate contribution, not the trust distribution. As noted previously, in applying the principle of *Old Colony Trust*, the corporate contributions are to be considered a payment to the shareholder which is then transferred by him to the trust. It is of no consequence that the payment actually bypasses the shareholder and goes directly to the trust. It is axiomatic that a shareholder may not defer the recognition of dividend income merely because dividends were never formally declared.¹⁰⁵ Conceptually, there is little difference between a shareholder directing that his dividends be held by the corporation for his benefit and a shareholder directing that they be distributed to a third party also for his benefit. In both instances, the shareholder lacks actual receipt of the dividends, though he receives the benefit. The two situations should be treated alike: a shareholder should not be permitted to delay taxation by a transfer to the trust.

B. *Personal Liability*

In the nondividend situation, there remains the question of who incurs the income tax liability: the qualified employee or the beneficiary child.¹⁰⁶ Rev. Rul. 75-488 concludes that when distribution rights become vested, "the parent-employee of the child who has incurred the expenses is required to include the amount of the distribution in his gross income."¹⁰⁷ To the extent that the contributions are noncompensatory, certain factual circumstances must exist before this conclusion can be supported under the economic benefit theory. For example, if the child's college expenses are incurred by the parents directly, such that they assume personal liability for them, the parent is taxable for the amount of the contribution attributable to those expenses. The general principle dictates that when a third party discharges the personal liability of a taxpayer, the discharge is income to the taxpayer in the amount by which the obligation is reduced.¹⁰⁸ The rationale underlying this theory is that the taxpayer receives an economic benefit since his assets would otherwise be required to meet this liability. The payment then by the third party is treated as a cash equivalent. The same result would obtain if the child technically incurred the expense in his own name, but the parent had an underlying legal obligation to meet the costs.¹⁰⁹ If the child, however, incurs the expense on his own and there is no concurrent obligation on the parent's part, the distribution clearly economically benefits the child.¹¹⁰ In this latter situation it is the child who realizes the income as recipient of the benefit.¹¹¹

105 2 MERTENS, *supra* note 76, § 10.99, at 34-35.

106 Obviously, when the contribution is considered a dividend, the shareholder is deemed in receipt of taxable income.

107 Rev. Rul. 75-488, 1975 INT. REV. BULL. No. 42, at 6.

108 *See* 279 U.S. 716.

109 For example, the underlying legal obligation could be pursuant to a child support statute, a divorce decree, or contract which required the employee parent to meet these expenses.

110 Obviously, in a situation where the parent is not obligated to provide a college education for his child, a free college education primarily benefits the child who receives it.

111 *See* Henkel & Hackett, *supra* note 1, at 346.

The same considerations are again involved when a distribution is deemed compensation. Although in its Revenue Ruling the Service concluded that a distribution is taxable as compensation to the parent, when payments do not result in the discharge of a legal obligation the income is taxable to the child beneficiary. In *Paul A. Teschner*,¹¹² the Tax Court considered the taxability of a prize that was won through the efforts of Teschner, but was payable to his daughter. In accordance with the rules of the contest, Teschner was not eligible to receive the prize himself, and could only designate the recipient. Teschner selected his daughter, who later received the prize. From this arrangement, he contended that the prize money should be included in his daughter's income rather than in his own. The Commissioner, however, contended that the prize constituted compensation to Teschner, and as such was includible in his income. This conclusion was based on the premise that compensation is to be attributed, as taxable income, to the person who earns it.¹¹³ The Tax Court, in holding for Teschner, narrowed the application of that principle used by the Service. The court stated that when "an individual neither receives nor has the right to receive income, he is not the taxable individual."¹¹⁴ In this case, Teschner had the power to appoint the recipient of the prize, but he had no power to dispose of the income. The power to designate the beneficiary, unlike the power to dispose, was not sufficient to give him any right to receive the income.

Applying the *Teschner* holding to an EBT situation, it is apparent that the employee is not the recipient of taxable income. Not only is he without the power to dispose of the income, but he also lacks the power to designate its recipient; he neither receives nor has any right to receive the income. Therefore, the child beneficiary actually receiving the distribution is the proper party to be taxed.

V. Conclusion

Provided the EBT does not take the form of a constructive dividend, it is a viable, tax-advantageous employee fringe benefit. When contributions are made with intent to compensate, and are offset by actually rendered services, deductibility is certain. Moreover, the contributions do not fall within the deferred deduction provisions of § 404(a), as interpreted by *Latrobe*. It is difficult to conceive of any basis which could support a finding that an EBT contribution is similar to a pension, stock bonus, profit sharing, or annuity plan. This is not to say, however, that the Internal Revenue Service's ruling on EBT's will be ineffective. Until the ruling is successfully challenged, cautious tax advisors will probably direct their clients away from this type of fringe benefit. While the Service will perhaps achieve less success through this indirect rejection of the *Latrobe Steel* decision than it might otherwise realize on appeal, it avoids the more substantial risk of losing an appeal.

¹¹² Paul A. Teschner, 38 T.C. 1003 (1962). The appeal in this case was dismissed for lack of prosecution. It should also be noted that, although still good law, the court was sharply divided, with seven judges dissenting.

¹¹³ Lucas v. Earl, 281 U.S. 111 (1930).

¹¹⁴ 38 T.C. at 1009.

It must be recognized that the major tax advantage, the immediate deduction, rests largely on the *Latrobe Steel* case. A reversal of *Latrobe Steel* on appeal could substantially alter the tax advantages by reinvoking the much broader interpretation of *New York Seven-Up*. Until such time, however, the EBT should be considered primarily in light of *Latrobe Steel*. The corporate contribution should be recognized as a business expense which is deductible in the year it is made, regardless of the year the trust corpus is distributed. Although compensation to the employee, the child beneficiary will generally be the taxable party; however, no tax should be assessed until the funds are actually distributed. Prior to distribution there is not sufficient control over his child's account to constitute a taxable interest.

When the contributions are restricted to the benefit of shareholders only, whether by express designation or by actual operation, the tax advantages of the EBT are significantly diminished. In such a situation, the courts are likely to construe the contributions as corporate distributions for the personal benefit of its shareholders. Accordingly, the corporation would be denied any deduction for its contribution. A similar result would obtain, though to a lesser degree, if the contributions were found to be excessive compensation. Additionally, under the *McCandless Tile* rationale, a corporation risks a finding that part of even reasonable compensation may be deemed a dividend, absent a history of formally declared dividends.

The facts of Model No. 2 strongly support a constructive dividend conclusion, primarily on the basis of the personal benefit theory. Not only will the corporation lose its deduction, but the shareholder should be prepared for an immediate tax assessment against him under an application of constructive receipt principles. Accordingly, a corporation seeking to disguise a distribution of earnings should consider a less conspicuous arrangement.

John Gaal