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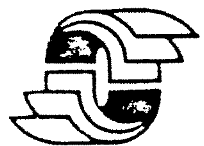

A PANEL PUBLICATION

Tax Viability of an Educational Benefit Trust

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With annual costs of college education often exceeding $5,000, educational fringe benefits to children of employees have become popular. To satisfy this genuine employee need, employers have turned to educational benefit trusts (EBTs). This article discusses this type of trust, the tax effect on both employer and employee, and the mechanics of its operation.

An EBT is a trust funded by current annual contributions from a corporate employer to provide for the future college or post-graduate educational expenses of the children of employees. There are no legal obstacles to setting up such a trust.

Tax Consequences to the Employer

Contributions to the trust by the corporation should be "ordinary and necessary" business expenses and therefore deductible.[1] The litigation in this area has centered around the timing of the deduction.

Specifically, the Internal Revenue Service has argued[2] that the EBT is a plan of deferred compensation with the deductibility of expenses governed by Code Section 404. Code Section 404(a) allows deductions for "contributions paid by an employer to or under a stock bonus, pension, profit-

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1. This point was conceded by the government in the most recent case, Greensboro Pathology, P.A. v. United States, 83-1 USTC Paragraph 9112, at 86,049 (Fed. Cir. 1982).

2. *E.g.*, Greensboro Pathology Associates, P.A. v. United States, 83-1 USTC Paragraph 9112 (Fed. Cir. 1982); Grant-Jacoby, Inc. v. Comm'r, 73 T.C. 700 (1980); Citrus Orthopedic Medical Group, Inc. v. Comm'r, 72 T.C. 461 (1979); *Rev. Rul. 75-448*, 1975-2 C.B. 55.

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. . . ."[3] The timing of this deduction, for a nonqualified plan,[4] such as an EBT, is governed by Code Section 404(a)(5)[5] or Section 83(h),[6] and is available when the contribution is included in the income of the employee. Under IRS's position, therefore, the deduction is not available to the corporation until the money is actually paid out from the trust.

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3. Code Section 404(a).

4. A qualified plan is a deferred compensation plan, such as a stock bonus, pension, or profit-sharing plan, that the Service has determined meets the requirements of Section 401(a) of the Internal Revenue Code of 1954, as amended. The trust established by such a plan is tax-exempt pursuant to Code Section 501(a). Although qualification results in the tax-free accumulation of income, it also entails compliance with numerous restrictions on the maximum and minimum benefits, maximum and minimum contributions, as well as stringent nondiscrimination requirements. An EBT is designed to be a nonqualified plan.

5. Code Section 404(a)(1)-(4) governs deductions for contributions to qualified plans, or plans meeting the requirements of Code Section 401(a) and the exemption under Code Section 501(a). Code Section 404(a)(5) provides:

> (5) OTHER PLANS—If the plan is not one included in paragraph (1),(2), or (3), in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if separate accounts are maintained for each employee.

6. Code 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 peson 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. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

Code Section 83(h) provides:

> (h) DEDUCTION BY EMPLOYER—In the case of a transfer of property to which this section applies . . . , 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), (b), 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.

Reg. §1.83-6(a)(3)(1978) provides that if Code Section 404(a)(5) or Reg. §1.162-10(a) applies, then Section 83(h) does not apply.

Taxpayers, on the other hand, have argued that the EBT is a "welfare or similar benefit plan," with deductibility of its expenses governed by Code Section 162. Reg. §1.162-10 denotes a number of plans that are specifically termed welfare plans, under which the expenses are currently deductible under Section 162 as ordinary and necessary business expenses. Reg. §1.162-10 includes "[a]mounts paid or accrued . . . for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan."[7] Under the taxpayer's position, the corporation would be able to obtain the deduction at the time of its contribution to the trust.

The problem in differentiating between a plan of deferred compensation and a welfare plan is that many welfare plans specifically enunciated in Reg. §1.162-10 contain elements of deferred compensation. The Tax Court, in *Grant-Jacoby, Inc.*[8] has noted:

> Section 404(a) and its predecessors have never been applied to all plans of deferred compensation. The plans described in Section 1.162-10, Income Tax Regs., are also plans of deferred compensation. The services which earn an employee the right to receive dismissal wages may be performed in one year, but he may not receive the dismissal wages until many years later. Similarly, unemployment benefits or accident and health benefits may be paid years after the performance of the services to which they are attributable.[9]

Greensboro Pathology Associates, P.A.,[10] is the most recent pronouncement in this area. Distinguishing previous cases and the Service's ruling in this area, the United States Court of Appeals for the Federal Circuit held that the educational benefit trust established by Greensboro Pathology was a welfare plan since it was concerned with the well-being of the employees and their families. Thus, the contributions made by the corporation were deductible under Section 162 in the year in which they were made.

The *Greensboro* court distinguished the only revenue ruling issued by the government in this area, *Rev. Rul. 75-448.*[11] The revenue ruling is based upon an EBT established for the purpose of furthering the education of the children of "key" employees—"key" being defined in terms of an employee's length of service and earnings level. The amounts contributed to the EBT were based on the parent's employment and compensation, rather than on a competitive basis of need, merit, or motivation. Because

7. Reg. §1.162-10(a)(1958).
8. 73 T.C. 700 (1980).
9. *Id.* at 713.
10. 83-1 USTC Paragraph 9112 (Fed. Cir. 1982).
11. 1975-2 C.B. 55.

of the compensatory character of the corporate contributions, the Service found the EBT to be a form of deferred compensation. The contributions were governed by Section 404, deductible when included in the employees' gross incomes.[12]

In *Greensboro*, participation in the EBT was open to all employees without restriction or qualification.[13] This fact proved to be one of the most important to the court in determining that the EBT was instead a welfare plan with contributions currently deductible under Section 162.

The Federal Circuit Court in *Greensboro*, however, emphasized that there was "no single differentiating factor,"[14] but rather a set of factors. The court rejected the two-pronged test advanced by the Service. Under the Service's test, a plan is one of deferred compensation when the benefit is large enough not to be considered a fringe benefit and when benefits are lost upon termination of employment.[15]

Instead of a two-pronged test, the Circuit Court in *Greensboro* provided a list of seven questions, holding that this multiple inquiry determines whether a plan is one of deferred compensation under Section 162 or a welfare plan under Section 404. The inquiry is:[16]

1. Is this a welfare plan . . . one concerned with the well-being of the employees?
2. Are the benefits provided employees based upon the employer's earnings?
3. Do the benefits increase for those who have been employed longer by the employer?
4. Are benefits provided to all the employees?
5. Are the plan benefits a substitute for salary?
6. Does the plan serve its stated purpose or is it a sham?
7. Does the employer lose control of the funds it gives the plan? Is there any sort of reversion of funds to the employer? Is the plan independently administered?

Clearly, the purpose of the plan must be for the well-being of the employees and their families—that is, a welfare benefit plan—in order for deductions to be currently deductible.

The benefits of an EBT should not be based upon the company's earnings. Otherwise, the EBT more closely resembles a profit-sharing plan, with deductibility of contributions governed by Section 404. An EBT also resembles a profit-sharing plan where the benefits are restricted to owners.

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12. *Id.*
13. 83-1 USTC Paragraph 9112 at 86,047.
14. *Id.* at 86,049.
15. *Id.*
16. *Id.*

For example, in *Grant-Jacoby*, about 10% of the employees participated in the EBT, and the participating employees together owned over 90% of the corporation's stock.[17] In *Grant-Jacoby*, the EBT was classified as a deferred compensation plan.

The EBT classified as a deferred compensation plan in *Rev. Rul. 75-448* provided benefits only for key employees. Thus, if the EBT provides benefits only to the children of key employees, i.e., those employed longest by the employer, then again the plan resembles one of deferred compensation. In order to avoid classificiation as a plan of deferred compensation, both participation and benefits in the EBT cannot be based on length of service or earnings level.

The *Greensboro* court, however, was concerned more with who was provided the benefits rather than with who is eligible to participate in the EBT. In *Citrus Orthopedic Medical Group, Inc. v. Commissioner*,[18] eligibility in the EBT was open to all employees, but the only employees were the shareholders and directors. The EBT in *Citrus Orthopedic* was held to be a plan of deferred compensation. Thus, the plan should benefit all the employees—including other than key employees.

Another determining factor put forth by the court in *Greensboro* is that the employee's compensation should be irrelevant in determining the amount or type of benefit provided. When the receipt of the benefits is in any way linked to salary, the plan looks too much like a deferred compensation plan rather than a fringe benefit or welfare benefit plan. Also, the employee should not have a choice of participating in the plan or receiving a salary increase. If the employee could obtain a salary increase instead, the EBT resembles a plan of deferred compensation.

In addition, the EBT must serve a purpose, and not be a sham. The *Greensboro* court cites the EBT in *Citrus Orthopedic* as a sham,[19] where the only employees were the sole shareholders (who also happened to be the only directors). The EBT did not serve its stated purpose. By having control over the trust funds, the corporation could simply use the EBT as a tax-deductible method of distributing the profits to the owners.

Another important and related factor is the existence of an independent trustee. The corporation, shareholders, and executives should not retain an inordinate amount of control over the trust funds. In *Citrus Orthopedic*, the court disallowed current deductions by the corporation because the

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17. According to the Tax Court, Grant-Jacoby, Inc. employed about 50 to 60 people during the years they had the EBT. 73 T.C. at 702. Yet, five executives, who were also shareholders, were the only employees eligible to participate under the plan for a four-year period from the time the company adopted the EBT. *Id.* at 703.

18. 72 T.C. 461 (1979).

19. 83-1 USTC Paragraph 9112 at 86,050.

two shareholders essentially retained absolute control over the investment and distribution of the trust fund. "Despite the technical elegance of the instruments,"[20] the trustee (the shareholders' attorney) had no real authority over the assets of the plan. Thus, *Citrus Orthopedic* can be distinguished by the existence of an independent trustee, which would indicate that the corporation, shareholders, and executives do have control over the trust funds. In addition, there was an independent plan administrator in *Greensboro*. An independent plan administrator shows more strongly that the key people do not have control over the trust.

Therefore, if the above factors are followed, pursuant to *Greensboro*, the deduction should be available to the corporation under Section 162.

The Service, however, may not accept the results of *Greensboro*. For example, in *Letter Ruling 7905005*,[21] the Service stated that "liberal eligibility requirements of the taxpayer's educational benefit plan do not take it outside the rule established in *Rev. Rul. 75-448* . . . ."[22] Additionally, the ruling stated that if benefits under the plan are conditioned upon the employee's continued relationship with the employer, the EBT will be considered compensatory, and therefore, the contributions will be deductible only when they are includible in the employee's gross income. In this ruling, the Service seems to indicate that even if the plan is completely nondiscriminatory,[23] Section 404 should apply to deductibility.

Nevertheless, the *Greensboro* case is an important and persuasive authority. Although the Service may challenge its rationale, *Greensboro* precedential authority is available to taxpayers all over the country who take their cases to the Claims Court, decisions of which are appealable to the new Federal Circuit Court that decided *Greensboro*.

Tax Consequences to the Employee

The tax consequences of the EBT benefits to the employee were not an issue in *Greensboro*. *Rev. Rul. 75-448* and *Armantrout v. Commissioner*[24] are the leading authorities on this subject. Both state that once the right to receive a distribution from the EBT becomes vested, the parent-employee of the child is required to include the amount of the distribution in his or her gross income in the taxable year of vesting.

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20. 72 T.C. at 464.
21. April 13, 1978.
22. *Id.*
23. In the EBT examined in *Letter Ruling 7905005*, there were no "criteria for eligibility such as salary limitations, years of service requirement and work performance." *Id.* As a result, all employees of the employer, a professional corporation, were eligible to participate. Nevertheless, IRS had extended the rule of *Rev. Rul. 75-448* to classify the EBT as a deferred compensation plan.
24. 570 F.2d 210 (7th Cir. 1978).

The preferable result is to have the distribution (once vested) taxable at a lower tax bracket, that is, to the child rather than to the employee. In *Armantrout,* the court did not allow the children to include the benefits from the EBT in their gross income. The income was includible in the gross income of the parent-employee because the benefits are a form of compensation to the employees. Otherwise, the EBT was simply a tax-avoidance scheme. The key employees, the only employees eligible to participate in the EBT, could negotiate with the employer to receive EBT compensation in another form, especially if they did not have children who could benefit from the plan.

An EBT can be distinguished from the plan in *Armantrout* if it can be shown that the benefits are not a bargained-for form of compensation. If the employee has no right to either control the amounts contributed to the EBT or receive additional compensation if not participating in the plan, then the EBT may not be considered an anticipatory assignment of income, as was the case in *Armantrout.*[25]

Nevertheless, Section 83 is another basis for the decision in *Armantrout* and in *Rev. Rul. 75-448.* Under that section, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, then the income is taxable to the employee in the year in which the rights are not subject to a substantial risk of forfeiture.[26]

It is difficult to argue that Section 83 does not apply to an EBT.[27] Welfare plans governed by Section 162 and deferred compensation plans of Section 404 both have elements of compensation. The employer provides fringe benefits because his employees work for him. Even if the EBT is seen as a welfare plan, the EBT benefits are provided by the employer in order to attract and retain the services of employees.[28] Rights under the EBT, however, are subject to a substantial risk of forfeiture until the child of the employee-participant actually begins to receive benefits.[29] Thus, even if Section 83 applies, the educational benefits would not be taxed to the employee until they are received.

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25. The Seventh Circuit, citing *United States v. Basye,* 410 U.S. 441, 450, followed the general principle, "that one who earns income may not avoid taxation through anticipatory arrangements." 570 F.2d at 212.

26. Code Section 83(a).

27. Code Section 83(e)(2) provides that Section 83 does not apply to "the transfer to or from a trust described in section 401(a) . . . ."

28. *See, e.g., Greensboro,* 83-1 USTC paragraph 9112 at 86,048–49.

29. If the parent leaves the employ of the employer who sponsors the EBT, then no benefits are received. Since continued employment is not guaranteed, benefits are subject to a substantial risk or forfeiture.

Tax-Exempt VEBA Possibility

In holding that an EBT is a welfare plan, the Federal Circuit Court in the *Greensboro* case was concerned solely with the timing of the deduction allowed the corporation for its contribution to the trust. The result of *Greensboro* raises the possibility that educational benefits may be provided under a tax-exempt trust, a Voluntary Employees' Beneficiary Association (VEBA).[30]

A VEBA is a tax-exempt organization that provides for the payment of life, sick, accident, or other benefits to its members or their dependents.[31] A VEBA's membership consists of employees who share a common employment-related bond.[32]

A VEBA specifically cannot provide any benefit that is similar to a pension, annuity, stock bonus, or profit-sharing plan. Similarity is present if the benefit will provide for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event.[33]

Greensboro holds that an EBT is a welfare, not a deferred compensation, plan. Nevertheless, it could be argued that the benefits of an EBT become payable with the passage of time, when the employee's child reaches college age. Since a college education is not a certainty for every child, however, such an educational benefit is payable as the result of an unanticipated event. Thus, an educational benefit for dependents is not a benefit that specifically cannot be provided to the employee-members of a VEBA.

Nevertheless, educational benefits for dependents are clearly not one of the permissible life, sick, or accident benefits. The question, therefore, is whether they are included in the term "other benefits."

The other benefits that a VEBA can provide must be similar to life, sick, or accident benefits.[34] Such similarity is present if the benefit is "intended to safeguard or improve the health of a member or a member's dependents,"[35] or if the benefit "protects against a contingency that interrupts or impairs a member's earning power."[36]

30. Code Section 501(c)(9).
31. *Id.*
32. Reg. §1.501(c)(9)-2(a)(1) (1980).
33. Reg. §1.501(c)(9)-3(f) (1980).
34. Reg. §1.501(c)(9)-3(d) (1980).
35. Reg. §1.501(c)(9)-3(d)(1) (1980).
36. Reg. §1.501(c)(9)-3(d)(2) (1980).

As an example of other benefits, the VEBA regulations provide for education or training benefits or courses, such as apprentice training programs, for members because these benefits protect against contingency that interrupts earning power.[37] Since this example provides only for educational benefits for employee-members, and not for dependents, it could be argued that such benefits for children were intentionally omitted. A member's earning power is not interrupted because his child attends college.

Nevertheless, the VEBA regulations provide that another example of permissible VEBA benefits is "any benefit provided in the manner permitted by paragraphs (5) *et. seq.* of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, as amended, 29 U.S.C. 186(c) (1979)."[38]

Those sections of the Labor Management Relations Act permit union-sponsored plans that provide most of the benefits expressly approved in the VEBA regulations, as well as educational scholarships for the children of employees.

There may be some reason for the Service to allow a union-sponsored VEBA that provides educational benefits for dependents, but not to allow a nonunion-sponsored VEBA that provides the same benefits. A union-sponsored VEBA would have an independent trustee and more liberal eligibility requirements. Nevertheless, a VEBA providing educational benefits to the children of nonunion employees, modeled after the EBT in *Greensboro,* would most surely have these safeguards. Thus, the Service may find it difficult to rationally discriminate against a nonunion VEBA providing educational benefits for dependents.

Also, the VEBA regulations provide that the term "other benefits" includes "*any* benefit provided *in the manner permitted*"[39] by the Labor Management Relations Act, except as otherwise provided. EBT benefits are not specifically prohibited in the regulations. A nonunion-sponsored VEBA would be providing this benefit *in the manner permitted* by the Taft-Hartley Act.

If the EBT is not or cannot be a VEBA, however, there is no tax-free accumulation of earnings in the trust. It is noted, however, that an EBT is a trust and therefore a separate taxable entity. Thus, assuming a principal fund of $235,555, yielding 9%, or $21,200 taxable income, it attracts only $5,167 tax in 1983.

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37. Reg. §1.501(c)(9)-3(e) (1980).
38. *Id.*
39. *Id.* (emphasis added).

Conclusion

An EBT is a practical entity to provide a valuable fringe benefit to employees. Under *Greensboro,* the corporation enjoys a deduction each year the contribution is made. The employee obtains a deferral until the time the benefits are received by the child.

An employer instituting an EBT should take advantage of the *Greensboro* holding. The *Greensboro* result, however, hinges on a number of plan characteristics that must be incorporated into the drafting of an EBT.

All employees must be eligible. Funds may not revert to the employer. There must be participants other than key employees. The trustee must be independent, and the plan administrator should be independent. Contributions must not be based upon profits. There cannot be an alternative of a salary increase for an employee who chooses not to participate. Finally, the employer cannot retain an inordinate amount of control over the actions of the trustee or plan administrator or the trust funds. With an EBT, there is the additional, advantageous possibility of the tax-free accumulation of income as a 501(c)(9) trust.