A Private Letter Ruling May Offer New Compensation Planning Opportunities

The possibilities of a new deferred compensation arrangement may flow from a flawed analysis.

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Earlier this year, the IRS issued Ltr. Rul. 9810005, which involved a deferred compensation funding arrangement between Kaiser, a tax-exempt HMO, and Permanente, the taxable physician group that provides medical services to Kaiser.

Under the arrangement, Kaiser makes regular contributions to an irrevocable trust, the assets of which are not subject to claims of creditors of Kaiser, Permanente, or the participants in the deferred compensation arrangement. Kaiser is required to make periodic contributions to the trust. As Permanente's deferred compensation obligations mature, the trust makes distributions to Permanente in amounts sufficient to enable it to discharge those obligations. The IRS ruled that the contributions by Kaiser to the trust do not result in current taxable income for either Permanente or the plan participants.

If this ruling is correct, it offers exempt organizations and related taxable employers an innovative way to avoid some of the adverse tax consequences and lack of security typically associated with nonqualified deferred compensation.[1]

THE RULES

For many years, the cornerstone of most employer-sponsored retirement programs has been a tax-qualified pension or profit sharing plan. Qualified plans offer numerous advantages:

- The employer's contributions to the plan are generally deductible for federal and state income tax purposes and in computing unrelated business taxable income.[2]
- The retirement trust fund is tax-exempt, so generally no taxes are paid on its investment income (other than unrelated business income).
- Employees are not taxed currently on the amounts accumulating for them under the plan, and generally pay no tax until they begin to receive benefits. Even then, they may qualify for favorable averaging treatment or may defer taxation by transferring funds received from the plan to another qualified plan or to an individual retirement account.[3]
- The plan's assets are held in a separate trust fund that is immune from the claims of the employer's creditors and, with some exceptions, from the claims of the employees' creditors.[4]

The number of Americans over age 65 is projected to increase dramatically in the next 40 years and, given current budget deficits, it is unrealistic to expect Social Security and Medicare benefits for tomorrow's senior citizens to be as valuable as they are today. Accordingly, there has never been a greater need for a strong private pension system. Unfortunately, pension coverage is no longer expanding. Indeed, among small employers, which have been responsible for the majority of new job creation in recent years, pension coverage is actually shrinking.

A series of tax laws passed since 1982 has greatly increased the cost and complexity of spon-

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soring a qualified retirement plan, and has in many cases dramatically reduced the benefits that may be provided for key employees. In 1982, for example, a qualified defined benefit pension plan could pay a 55-year-old retiree as much as $136,425 per year; the 1998 maximum is approximately $60,000.[5] Similarly, in 1982 an employer could contribute as much as $45,475 per year to a defined contribution plan on behalf of an employee; the 1998 maximum is $30,000.[6] Further, many large exempt organizations, such as hospitals, are unable to contribute the maximum amount for their key executives because the qualified plan nondiscrimination rules would require them to contribute substantial amounts for rank-and-file employees.[7]

Tax laws passed since 1982 have greatly increased the cost and complexity of qualified retirement plans, and in many cases, have dramatically reduced benefits.

The federal budget legislation passed in 1993 increased the attractiveness of nonqualified plans. The higher personal income tax rates introduced by OBRA '93 enhanced the value of tax deferral. In addition, OBRA '93 reduced, from $235,840 to $150,000, the amount of compensation that can be taken into account under a qualified plan.[8] The combination of Section 401(a)(17) and the Section 415 limitations has resulted in many executives receiving significantly lower benefits under qualified plans, thus creating the need for nonqualified plans to cover the shortfall.

Even when the private pension system was still growing, most large employers and many small employers provided supplemental retirement benefits for key employees. Major reasons for doing so included:

- Recruiting and retaining talented executives.
- Developing a competitive compensation package.
- Providing incentives for superior performance.
- Providing retiree medical benefits.[9]

Because of the increasingly restrictive rules applicable to qualified plans, many more employers are replacing or supplementing qualified plan benefits with nonqualified deferred compensation programs.

Nonqualified deferred compensation plans. The Employee Retirement Income Security Act of 1974 (ERISA) regulates both employee pension plans and employee welfare plans, such as health plans. It covers both qualified and nonqualified pension plans.[10] Unless the plan is exempt under section 4 of ERISA (which exempts, among others, plans maintained by governmental employers and churches, including church controlled organizations such as church-run hospitals), a nonqualified deferred compenation plan will be subject to all of the requirements of ERISA, with potentially disastrous consequences (potentially including current employee taxation), unless the plan qualifies for one of the following exemptions.

- The plan is an unfunded excess benefit plan—one that exists *solely* to provide contributions or benefits in excess of the Section 415 limitations.[11] Funded excess benefit plans are subject to certain provisions of ERISA.
- The plan is an unfunded "top hat plan" that is maintained primarily to provide benefits to a "select group of management or highly compensated employees."[12] Unfunded top hat plans remain subject to certain ERISA provisions; funded top hat plans are subject to all applicable provisions of ERISA.

The U.S. Department of Labor (DOL) interprets the "select group" exception narrowly.[13] Its position is that if even one nonmember of the select group is covered, the plan is not a top hat plan.

Tax issues. Generally, a major objective in establishing and designing a nonqualified plan is

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[1] For other articles that discuss the ruling, see Sheppard, "IRS Lets Kaiser Make Nonqualified Plan Permanente," 78 Tax Notes 1459 (3/23/98) and Robbett, "Three Party Compensation Deferrals: An Analysis of PLR 9810005," 26 Tax Mgmt. Comp. Plan. Jnl. 195 (9/4/98).

[2] Sections 404(a), 512(a)(1).

[3] Sections 402(a), (c), (d).

[4] Section 401(a)(13); section 206(d) of the Employee Retirement Income Security Act of 1974 (ERISA); Patterson v. Shnmate, 505 U.S. 1239 (1992).

[5] Section 415(b).

[6] Section 415(c).

[7] Sections 401(a)(4), 410(b).

[8] Section 401(a)(17). The limit is indexed for inflation, and is $160,000 for plan years beginning in 1998.

[9] See, for instance, Ltr. Ruls. 8939050, 9107031, and 9112022.

[10] ERISA section 3(2).

[11] ERISA sections 3(36), 4(b)(5).

[12] ERISA sections 201(2), 301(3), and 401(a)(1).

[13] See, for instance, DOL Adv. Op. 90-14A, 17 BNA Pension Reporter 1074 (6/18/90).

ensuring that the employee will not be subject to income tax on deferred compensation until it is actually paid. There are obstacles, however, to achieving that result.

1. Unlike qualified plans, nonqualified plans are subject to the doctrine of constructive receipt.[14] Accordingly, neither the plan nor the actual practices of the employer may make the funds available to the employee before one of the events that triggers actual payment (reaching retirement age, terminating employment, death, disability, or change of control of the employer are the typical events).
2. If the deferred compensation is paid to a trust or escrow account, and so is set aside for the employee's benefit and outside the reach of the employer's creditors, the employee will be currently taxable even if he or she has no right to demand payment of the deferred amount.[15] The only exception is where the deferred compensation is subject to a substantial risk of forfeiture (as determined under Section 83), in which case the employee is not taxable until the risk of forfeiture lapses.

A "substantial risk of forfeiture" exists if the payee's rights to the property "are conditioned upon the future performance of substantial services."[16] There is no definition of "substantial services," nor any safe harbor definition of a "substantial risk of forfeiture." The regulations provide only examples of *potential* substantial risks of forfeiture. For example, an enforceable covenant not to compete "will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary."[17]

A substantial risk of forfeiture also exists where rights in property that are transferred are conditioned, directly or indirectly, on the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if the condition is not satisfied.[18]

Payment to a rabbi trust—an irrevocable grantor trust subject to the employer's general creditors—does not cause current taxation of the employee, because the assets of the trust must remain available to the employer's creditors, at least if the employer becomes insolvent.[19] Rabbi trusts have major drawbacks, though. One is that the trust is a grantor trust, so all of the trust's taxable income is taxable to the employer as grantor. Moreover, the employee bears the risk that the deferred compensation will be wholly or partly lost, and that he or she will be merely an unsecured general creditor, if the employer becomes insolvent. Accordingly, the employer and employee generally must choose between two less than ideal alternatives—current taxation with protection against creditors, or deferred taxation with limited protection against creditors.

Tax-exempt employers. An employee of a tax-exempt employer is in a worse position yet. He or she may be taxable currently under Section 457(f) with respect to the employer's mere promise to pay deferred compensation. There are three ways to avoid this result.

1. Adopting a plan that is not subject to Section 457. The most commonly invoked exception is that for a bona fide death benefit or severance plan.[20] Thus, for example, some tax-exempt employers have adopted split-dollar life insurance programs that will generate large policy cash values by the employee's anticipated retirement date. In the absence of any guidance from the IRS, these arrangements seem vulnerable to attack as being, in substance, deferred compensation rather than death benefit plans.

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[14] Reg. 1.451-2(a) provides that income is constructively received in the tax year during which it is (1) credited to the taxpayer's account, (2) set apart for the taxpayer, or (3) otherwise made available so that the taxpayer may draw on it at any time or could if he or she gave notice of intention to withdraw during the tax year. Income is not constructively received, however, if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

[15] Sections 61 and 83. Section 83(a) provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over any amount paid for the property is includable in the gross income of the person who performed the services for the first tax year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Reg. 1.83-3(e) provides that, for purposes of Section 83, "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. The term does, however, include a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditors, for example in a trust or escrow account. See also Sproull, 16 TC 244 (1951), *aff'd per curiam,* 194 F.2d 541, 41 AFTR 849 (CA-6, 1952); Rev. Rul. 60-31, 1960-1 CB 174, Situation 4.

[16] Section 83(c)(1); see also Section 457(f)(3)(B).

[17] Reg. 1.83-3(c)(2).

[18] Reg. 1.83-3(c).

[19] Rev. Proc. 92-64, 1992-2 CB 422.

[20] Section 457(e)(11)(A)(i).

2. Adopting a plan that qualifies as an "eligible deferred compensation plan" under Section 457(b). This requires, inter alia, that the deferred amounts continue to be general assets of the employer, available to pay claims of its creditors. In addition, the annual deferral generally is limited to $8,000, reduced by deferrals under certain other plans, such as Section 401(k) and Section 403(b) plans.[21] In many cases, the allowable deferrals are simply insufficient to provide an adequate benefit.
3. Subjecting the employee's deferred compensation to a substantial risk of forfeiture, as defined for purposes of Section 83.[22]

This prospect of employees facing current taxation on their deferrals presents the tax-exempt employer with difficulties in structuring satisfactory deferred compensation arrangements for senior executives and professional employees.

Reasonable compensation. Compensation arrangements adopted by exempt organizations for their executives must be reviewed for other reasons as well. These plans must not violate the long-standing proscriptions against private inurement or private benefit. The presence of any private inurement, or more than an incidental amount of private benefit, may jeopardize the organization's tax-exempt status.

A more recent requirement is that nothing in the plan constitute an excess benefit transaction that could result in the imposition of intermediate sanctions excise taxes on disqualified persons or organization managers.[23] An "excess benefit transaction" is one in which an economic benefit is provided by a covered tax-exempt organization, directly or indirectly through a controlled entity, to or for the use of any disqualified person if the value of the economic benefit exceeds the value of the consideration (including the performance of services) received for the benefit. The disqualified person need not be a party to the transaction if he or she will benefit from it. The excess benefit may come directly from the exempt organization or indirectly through a controlled subsidiary.

The payment of reasonable compensation to employees or other service providers (including physicians) generally does not constitute private inurement or an excess benefit transaction.[24] Payment of excessive compensation does result in private inurement and an excess benefit transaction. The reasonableness of a compensation arrangement is determined by the particular facts and circumstances. In general, reasonable compensation is the amount that would ordinarily be paid for like services by a like organization (taxable or tax-exempt) under like circumstances.[25]

According to the House Ways and Means Committee Report on Section 4958, the existing standards under Section 162 apply in determining reasonableness of compensation for purposes of the Section 4958 intermediate sanctions rules.[26] "In this regard, the Committee intends that an individual need not necessarily accept reduced compensation merely because he or she renders services to a tax-exempt, as opposed to a taxable, organization."[27] The parties may rely on a rebuttable presumption of reasonableness for compensation that was approved by an independent board or committee that considered appropriate comparability data and adequately documented the basis for its action.

LTR. RUL. 9810005

In Ltr. Rul. 9810005, the IRS ruled on the consequences under Section 83 of a deferred compensation arrangement to be funded by an exempt organization, Kaiser, for the benefit of certain employees of Permanente,[28] a taxable corporation that provides medical services to Kaiser under an exclusive services contract ("the Contract"). Under the Contract, Permanente's principal compensation is a fixed payment that generally covers little more than its anticipated operating expenses.

The facts. Permanente maintains an unfunded, nonqualified supplemental retirement benefit plan ("the Plan") for employees whose benefits under Permanente's

[21] Sections 457(b)(2), (6). Section 457(g) contains special rules for government-sponsored plans.

[22] Secrion 457(f)(1).

[23] Section 4958(c)(1).

[24] See, however, B.H.W. Anesthesia Foundation, Inc., 72 TC 681 (1979) (private inurement may exist even if compensation is reasonable).

[25] Reg. 1.162-7(b)(3). See also Prop. Reg. 53.4958-4(b)(3)(1).

[26] H. Rep't No. 104-506, 104th Cong., 2d Sess. 41 (1996).

[27] *Id.*, fn 5.

[28] Of course, the ruling itself does not identify the parties by name. Further, it does nor indicate which employees of Permanente were eligible for the deferred compensation arrangemenr. It is assumed that, to avoid the ERISA problems discussed above, participation is limited to physicians and any other employees who are within the "select group of management or highly compensated employees."

qualified plan are limited by Section 401(a)(17), 415, or 414(q)(6).[29] To actually receive benefits under the Plan, employees must satisfy age and service requirements and must survive until the benefit commencement date. Once these requirements are satisfied, benefits are not subject to reduction or forfeiture.

The Contract calls for Kaiser to establish an irrevocable funded trust ("the Trust") for the benefit of Permanente, and make contributions to the Trust, providing Permanente with a source of funds from which to satisfy its obligations to employees under the Plan. Funds will become payable to Permanente from the Trust as Permanente's obligations to its employees under the Plan mature. Those funds then become general assets of Permanente, subject to claims of its creditors, and thus are not dedicated to the payment of benefits under the Plan.

The Trustee of the Trust has sole responsibility for the management, protection, conservation, and investment of Trust assets. The Trust provides that its assets are not reachable by the creditors of Kaiser, Permanente, or the Plan participants.

Contributions by Kaiser to the Trust will be calculated by reference to the total present value of the benefits Permanente expects to pay, disregarding turnover and mortality. On execution of the Trust, and annually thereafter, Kaiser will transfer to the Trust an amount equal to the total present value (assuming retirement at the earliest eligible date and no other terminations of employment) of all expected payments of benefits earned by the valuation date that could be made to employees who will not satisfy the age and service requirements for benefits until at least two years after the contribution.[30]

Each quarter, the Trust will pay Permanente an amount equal to Permanente's obligations to its employees under the Plan, as they mature, on the date the participant attains retirement age or actually retires (whichever is later).[31] Any overfunding of the Trust will revert *to Kaiser* at stated intervals.

All trust assets will be allocated to individual memorandum accounts in the names of the participating employees. The entire account will be forfeited *to Kaiser* if that employee does not become entitled to benefits under the Plan, for instance because he or she terminates employment before satisfying the age and service requirements.

Trust assets will also be forfeited *to Kaiser* if Permanente voluntarily terminates its relationship with Kaiser, or if Kaiser terminates its relationship with Permanente for cause.

For financial accounting purposes, Kaiser will expense all contributions to the Trust. Permanente will show the Trust assets on its balance sheet as an offset against its liabilities under the Plan.

The ruling. The IRS stated that the contributions by Kaiser to the Trust, in which Permanente holds a beneficial interest, represent a transfer of property under Section 83(a). Based on the surrounding facts and circumstances, however, the IRS concluded that a substantial risk of forfeiture exists because *Permanente's* rights in the property transferred are conditioned on the occurrence of an event related to the purpose of the transfer. The IRS also ruled that:

1. To the extent that the memorandum accounts are subject to a substantial risk of forfeiture under Section 83, Kaiser is treated as the owner of those amounts under Sections 671 and 677, because those amounts may be distributed to the grantor, Kaiser, without the approval or consent of any adverse party. Accordingly, Kaiser would be treated as the owner of this portion of the Trust.
2. To the extent that the memorandum accounts are not subject to a substantial risk of forfeiture, and are taxable to Permanente under Section 83, Permanente is treated as the owner of that portion of the Trust, because Permanente will receive the economic benefit of those memorandum accounts.

A major objective in designing nonqualified plans is ensuring that employees will not be subject to tax until the compensation is actually paid.

[29] Accordingly, the Plan is not an "excess benefit plan" because it provides benefits that cannot be provided under the qualified plan due to limitations other than those contained in Section 415.

[30] This paragraph summarizes the ruling's description of the contract's provisions, but appears to be inaccurate. Presnmably, with respect to all contributions after the first, Kaiser will contribute the total present value, reduced by the value of the assets already accumnlated in the Trust.

[31] The ruling states that, in the past, Permanente's cutrent payment obligations under the Plan were included in its operating expenses in determining the amount of the fixed paymeut by Kaiser. Accordingly, it seems that Kaiser's payments to the Trust merely replace payments that would otherwise have been made directly to Permanente, though the timiug and amounts will differ, as the benefirs are now being funded in advance, rather than on a pay-as-you-go basis.

3. The establishment of the Trust, the transfer of assets to the Trust, the allocation of those assets to individual accounts, the earnings on those Trust assets, and the distribution of any of those assets to Permanente, will not give rise to any income to the participants and beneficiaries of the Plan.

ANALYSIS

It is, of course, always a somewhat hazardous venture to design a compensation arrangement on the basis of a private letter ruling issued to another taxpayer, particularly because one cannot know the entire factual background. In the area of nonqualified deferred compensation, however, there is often little other new guidance, and many employers are anxious to find ways to circumvent the limitations described above.

Clearly, if the ruling is correct, it offers significant new planning opportunities, both for exempt organizations (with respect to their own employees) and for taxable organizations that provide services to exempt organizations. In addition, because the arrangement offers tax deferral to the taxable service provider, it should enable the tax-exempt purchaser to pay a lower price for the services.

The exempt organization as employer. In the usual case, executives' benefits under a tax-exempt employer's qualified plans and Setion 403(b) plans have effectively already been maximized, either because the executive is at the statutory maximum or because any additional contributions by the employer would require costly additional contributions for rank-and-file employees. The deferrals available under an eligible Section 457 deferred compensation plan generally are woefully insufficient. If current taxation of the employee is to be avoided, the employer can provide deferred compensation in two ways:

1. By funding an arrangement, such as a severance plan or a split-dollar life insurance program, that is arguably exempt from the Section 457 limitations.[32] In the absence of any guidance as to the scope of those exceptions, this is an aggressive technique, particularly if large amounts are involved.
2. By subjecting the benefits to a substantial risk of forfeiture, in which case the benefit is not taxable until the forfeiture provision lapses.[33] This exposes the employee to two distinct risks—that the deferred funds will be taken by creditors of the employer,[34] and that the forfeiture provision will take effect. Any attempt to limit the forfeiture risk involves another risk—that the IRS will not accept that the risk of forfeiture is "substantial."

Accordingly, transfer of the employees to a separate taxable employer is attractive, particularly if the technique approved by the ruling is viable. However, a couple of hurdles must still be overcome. First, the ruling was premised, at least in part, on representations that Kaiser and Permanente are independent and negotiate at arm's length. This would not be the case if one party controls or dominates the other, or for some other reason has a significantly superior bargaining position.

Moreover, Section 414(o) authorizes the Treasury to prescribe such regulations as may be necessary to prevent the avoidance of certain employee plan requirements, including those under Section 457, through the use of separate organizations, employee leasing, or other arrangements. In one ruling, involving a for-profit subsidiary of a Section 501(c)(3) organization, the IRS stated as follows:

> The Service has not yet published any proposed or final regulations under section 414(o) applying the section 457 provisions to any arrangement. Since it does not appear that Corporation C was established *as a device for its employees to defer income*, and since C appears to have business purposes for its deferral arrangement with them, we have assumed, without ruling, that section 414(o) will not require the aggregation of Corporation C with Corporation D and Entity E and the hospital owned by Entity E and thus will not require the application of section 457 to the deferral arrangement between C and its employees.[35]

The IRS might hold that the establishment of a separate taxable entity is a device, unless the parties can provide evidence of a legitimate business purpose for its establishment, other than avoidance of Section 457 or other limitations on deferred compensation plans of tax-exempt organizations.

Example—a taxable entity as employer. Assume that, as in the ruling, a taxable entity (P) provides services to a tax-exempt organiation (K). The annual compensation paid to P for those services

[32] Section 457(e)(11)(A)(i).

[33] Section 457(f)(1).

[34] Section 457(b)(6).

[35] Ltr. Rul. 9737013 (emphasis supplied).

includes an actuarially calculated amount that P sets aside in a rabbi trust to provide deferred compensation to its employees. If any of its employees forfeit the right to deferred compensation, or if the rabbi trust becomes overfunded, K reduces its future payments under the contract. K's required annual contribution is $100,000, payable on December 31 of each year. During 1998, various employees of P terminate employment, thereby forfeiting account balances totaling $10,000. This reduces K's 1998 contribution to $90,000.

In this example, P has the following income tax consequences:

- All payments received from K are currently taxable as compensation for services.[36] By contrast, the IRS ruled that Permanente did not have current taxable income.
- The income of the rabbi trust is taxable each year to P as the grantor.[37] Under the ruling, Permanente is taxable only on the income earned by accounts that are no longer subject to a substantial risk of forfeiture. Because an account does not vest until the employee has satisfied the age and service requirements for receipt of benefits, Permanente would be taxable only for a relatively short period.
- P does not receive a deduction until benefits are taxable to the individual employees,[38] which may be many years after the contributions are made to the Trust. Permanente, however, will have income only when it receives distributions from the Trust, and will distribute benefits (and thus become entitled to a deduction) shortly thereafter.

In the alternative. In the example above, assume that instead of using forfeitures to reduce future contributions to the Trust, K receives a refund of the forfeiture amounts. The possibility that a portion of the payments may have to be refunded at a later date should not reduce the amount taxable to P.[39] Any refunds would be deductible.[40]

It does not appear that there is any real difference between these two arrangements, nor any significant difference between the second arrangement and the arrangement described in the ruling. Thus, it appears that Permanente should be treated as being currently taxable on the amounts contributed by Kaiser to the Trust. It appears that the IRS has failed adequately to distinguish two separate issues:

1. Whether the benefits of an individual plan participant are subject to a substantial risk of forfeiture. Clearly they are, until the employee has satisfied the age and service eligibility requirements for receiving a benefit.
2. Whether Permanente has a substantial risk of forfeiture with respect to any of the amounts contributed by Kaiser to the Trust. The economic loss resulting from a forfeiture is suffered entirely by the employee. Permanente suffers no loss. How can Permanente be said to have a substantial risk of forfeiture?

The IRS ruled that neither the requirement of survival to retirement age nor the possibility of reversion to Kaiser on termination of the Contract was a substantial risk of forfeiture. It did rule, however, that:

- Permanente's rights in the property transferred were conditioned on an employee meeting the service eligibility requirement.
- This was a condition related to the purpose of the transfer—to provide Permanente with a source of money to fund its deferred compensation obligations to its employees (although the existence or amount of forfeitures does not affect the achievement of this purpose).
- Therefore, there was a substantial risk of forfeiture.

The IRS might hold that the establishment of a separate taxable entity is a device.

This analysis appears flawed. The purpose of the transfer by Kaiser was to fund Permanente's obligations to an entire class of employees, not to a single employee. In addition, in the context of the long-established and symbiotic relationship between Kaiser and Permanente, there is no difference in substance between (1) Kaiser receiving a reversion and (2) Kaiser simply crediting the amount forfeited by an individual employee towards a future contribution. For all practical purposes, the funds contributed by Kaiser are not subject to any, let alone a substantial, risk of forfeiture, as far as Permanente is concerned. Indeed, were this not the case, how could Permanente properly re-

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[36] Section 61(a)(1).

[37] Section 671.

[38] Section 404(a)(5).

[39] North American Oil Consolidated v. Burnet, 286 U.S. 417, 11 AFTR 16 (1932).

[40] Section 162(a).

port the Trust assets as assets on its balance sheet?

Basye. It is also somewhat difficult to reconcile the ruling with the Supreme Court's decision in *Basye,* 410 U.S. 441 (1973), which addressed an earlier version of the agreement between Kaiser and Permanente's predecessor, a partnership. Under the earlier agreement, payments by Kaiser to the trust could not be recouped by Kaiser under any circumstances. The lower courts failed to distinguish between forfeiture by Permanente of its compensation for services and forfeiture of benefits by individual participants, and held for the taxpayer.[41]

The Supreme Court reversed the Ninth Circuit, with only Justice Douglas dissenting. In his opinion for the Court, Justice Powell said:

> We hold that the courts below erred and that respondents were properly taxable on the partnership's retirement fund income. This conclusion rests on ... familiar principles of income taxation, first, that income is taxed to the party who earns it and that liability may not be avoided through an anticipatory assignment of that income.... There can be no question that Kaiser's payments to the retirement trust were compensation for services rendered by the partnership under the medical service agreement.... Payments to the trust, much like the direct payments to the partnership, were not forfeitable by the partnership or recoverable by Kaiser upon the happening of any contingency....[42]

The only significant difference between the agreement in *Basye* and the agreement described in the ruling is that the earlier agreement did not provide for any possibility of a reversion to Kaiser. As argued above, this is not enough of a difference to dictate a different result.

CONCLUSION

At first blush, Ltr. Rul. 9810005 appears to offer exciting planning opportunities for the many tax-exempt organizations that have close working relationships with taxable entities, particularly in the health care field. The Service's analysis of the Section 83 issues is not compelling, however. It is hard to conclude that, as a matter of business reality, either Permanente or its doctors believed that there was any substantial risk of forfeiture by Permanente of the amounts contributed to the Trust.

In addition, by making nonqualified plans mote attractive, the ruling undermines the policy objective of encouraging employers to deliver retirement benefits through qualified plans, which are required to provide benefits to rank-and-file employees as well as to highly paid employees.

It is, however, unfair that tax-exempt employers, which compete with taxable employers for talented executives, are subject to more stringent limitations on the types of deferred compensation that they can offer, thus forcing them to adopt artificial arrangements in which form is exalted over substance to a degree that is incompatible with the rational administration of the tax laws.[43] The law in this area could be greatly simplified by subjecting all private employers to the same rules. ■

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[41] Basye, 295 F. Supp. 1289, 23 AFTR2d 69-454 (DC Cal., 1968), *aff'd.* 450 F.2d 109, 28 AFTR2d 71-5649 (CA-9, 1971).

[42] 410 U.S. at 447-449. The tax years at issue in the case preceded the enactment of Section 83 in 1969.

[43] The unfairness is compounded by the recent liberalizations of the rules applicable to govetnmental plans. See Sections 415(b)(10), 415(m).