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Disqualification of Employee Trust: *Yarish v. Commissioner*

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Many trusts commonly encountered in the context of the funding of pensions and other forms of deferred compensation in the United States permit employees to defer income until it is received by them. These trusts include (i) plans that "qualify" under Internal Revenue Code sections 401(a) and 501(a), and (ii) so-called "rabbi trusts" that, although not "qualified," are treated as "grantor trusts" of the employer. However, other types of trusts are sometimes encountered in the pension context, including section 402(b) trusts, the principal focus of the discussion below.

By way of background: A trust that is a part of a stock bonus, pension or profit-sharing plan described in Code section 401 will be "qualified" if it meets numerous requirements set forth in the Code, one of which is that the assets of the trust be used for the exclusive benefit of employees of the employer. Although amounts contributed to such trusts are generally deductible by the employer when the contributions are made, those contributions, and the income thereon, are generally includible in the incomes of the employees or their beneficiaries only when distributed. (The trust itself is generally exempt from tax under Code section 501(a).)

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By contrast, a "rabbi trust" created by an employer to hold funds for the payment of nonqualified deferred compensation is formed under IRS guidance intended to insure treatment as a grantor trust.[1] In particular, the assets of the trust must be subject to claims of the employer's general creditors in the event of the employer's insolvency. The employer, as the "grantor" of the rabbi trust, is treated for most tax purposes as if it owned the assets of the trust. Consequently, it is not entitled to any tax deduction when contributions are made to the trust; and the income of the trust is taxed, as earned, to the employer. However, the existence and funding of a rabbi trust, if properly structured, generally do not require the employee to include any amounts in income until he receives those amounts under the plan.

Far different consequences arise from a trust described in Code section 402(b) (a "section 402(b) trust"). Although such a trust is generally funded by employer contributions and used to hold assets for the benefit of employees and their beneficiaries, the trust is neither exempt from tax under section 501(a) nor classified as a "grantor" trust with respect to either the employer or the beneficiaries of the trust.[2] A section 402(b) trust may arise when a qualified plan is not implemented or maintained properly, and therefore ceases to qualify under section 401(a), or it may be created intentionally.

In general, employer contributions to a section 402(b) trust are includible in the income of the employee when the employee's interest is no longer subject to a substantial risk of forfeiture (or at the time the contributions are made if the employee's interest is never subject to a substantial risk of forfeiture). The income earned by the trust, however, is generally not taxable to the employees until distributed to them[3]—subject to an important exception relating to highly compensated employees. If one of the reasons that a trust is not "qualified" is that it fails to meet certain requirements relating to minimum participation and coverage, each beneficiary of the trust who is a "highly compensated employee" ("HCE") must include in gross income each year "the vested accrued benefit of such employee (other than the employee's investment in the contract)" as of the close of the taxable year of the trust—effectively a mark-to-market approach—even in years in which no distribution is made to the employee.

The consequences of the application of this rule to HCE's are sufficiently punitive so as to make it unlikely that a U.S. employer would intentionally establish a deferred compensation arrangement that was subject to it. However, as previously noted, section 402(b) can apply in circumstances where qualified plans and related trusts intended to "qualify" under sections 401(a) and 501(a) fail to

maintain their qualified status. A recent Tax Court case, discussed below, presented such circumstances and required the court to consider whether the employee had an "investment" in the deferred compensation arrangement that could be taken into account to reduce the amount includible in his income when the government (retroactively) "disqualified" the plan.

Yarish

Yarish v. Commissioner[4] is the second Tax Court decision resulting from pension-related controversies relating to medical practice entities owned by plastic surgeon Robert Yarish. One such entity, Yarish Consulting, Inc. ("Yarish Consulting"), was an S corporation formed in 2000. An employee stock ownership plan (ESOP) acquired in the same year 90% of the shares of Yarish Consulting. Yarish participated in the ESOP and owned the other 10% of the shares of Yarish Consulting. Unsurprisingly, he was also an HCE. A determination letter had been issued by the IRS in 2001 to the effect that the ESOP was a "qualified" plan; however, the application for the determination letter did not disclose the existence of related medical practice entities also owned by Yarish, the employees of which entities did not participate in the ESOP. At the end of 2004, the ESOP was terminated and Yarish's entire account balance was rolled over to an individual retirement account at his direction.

Thereafter, the IRS audited the (now-terminated) ESOP and concluded that, taking into account the non-participating employees of the related medical entities owned by Yarish that had not been disclosed in seeking qualified plan status for the ESOP, the ESOP failed to meet relevant coverage requirements throughout the period of its existence. The IRS revoked the favorable determination letter previously issued with respect to the ESOP, retroactive to the year of its formation.

The IRS further asserted an income tax deficiency against Yarish for 2004 on the basis that his entire account balance in the ESOP was includible in his income for 2004. Because the statute of limitations had expired for all years prior to 2004, any income tax deficiency would have to be asserted for 2004 in order not to be time-barred, even though the ESOP was disqualified for earlier years as well.

Before the Tax Court, it was undisputed that Yarish was an HCE, that he was required to include his "vested accrued benefit" in income during 2004, and that Yarish had not taken any portion of the amounts in the ESOP into income in any prior year. The government and Yarish did not agree, however, as to the *amount* required to be included in the income of Yarish, and both sides sought summary judgment on that issue.

Under the Code, the amount to be included in income was Yarish's vested accrued benefit "other than the employee's investment in the contract," and the question before the court was whether Yarish had any such investment in the deferred compensation arrangement in 2004. Because no amount had been contributed to the ESOP by Yarish and he had not paid tax on any of the property held in the ESOP prior to 2004, the government contended that his "investment in the contract" was zero, and therefore that the entire accrued benefit in 2004 had to be included in his income for that year.

Yarish argued that, although the term "investment in the contract" was not defined in section 402(b) or the regulations thereunder, it was defined in provisions of Code section 72, relating to annuities, and that such definition should be controlling here given the related subject matter of sections 72 and 402. In particular, an employee's investment in a contract for purposes of section 72 includes not only amounts paid by the employee, but also amounts contributed by the employer "to the extent that such amounts were *includible* in the gross income of the employee" (emphasis added). Since the plan was disqualified retroactively to 2000, the amounts contributed to the ESOP in years prior to 2004 could be said to have been "includible" in income in those earlier years, even though not actually reported as income. Therefore, Yarish argued, those amounts had to be included in his investment in the contract for 2004, and only the *increase* in the accrued benefit from the end of 2003 to the end of 2004 should be included in his income for 2004.

The court found the government's position more persuasive. The court noted that, although the phrase "investment in the contract" appeared in both section 72 and section 402, the phrase did not necessarily have the same meaning in both places, especially since the concept was applied in the two Code sections for different purposes—with section 72 addressing the taxation of distributions, while section 402(b)(4) addresses the taxation of HCE's on the basis of accrued benefits, without regard to distributions.

The court also gave substantial weight, in view of the ambiguity of the statute, to discussion in the Conference Report to the Tax Reform Act of 1986, quoted in the opinion, to the effect that an HCE is taxable on the value of his vested accrued benefit attributable to employer contributions and on income on any contributions "to the extent such amounts have not previously been taxed to the employee." It is noteworthy, however, that the specific legislative history cited was that of the Tax Reform Act of 1986, enacted two years before Congress added the "investment in the contract" phrase to section 402(b). (The 1986 Act's language, which provided for an offset of the accrued benefit solely by "employee contributions," was more supportive of the government's position.) The court also believed that the government's interpretation was more consistent with the Congressional purpose underlying section 402(b), which the court perceived to envision that any HCE include in income his accrued benefit to the full extent not previously taxed to the employee.

The *Yarish* opinion also notes that the government had argued, in the alternative, that the duty of consistency (sometimes referred to as "quasi-estoppel") estopped Yarish from seeking to reduce his 2004 income inclusion by

arguing that his vested benefit was includible in income in a year prior to 2004. Presumably the estoppel would arise from the petitioners' treatment of the ESOP as a qualified plan such that Yarish's account balance was not included in his reported income in any year prior to 2004. The court concluded that it need not address this argument in light of the court's conclusion that the entire amount of the vested benefit of Yarish in the ESOP was includible in his income in 2004 under the terms of section 402(b).

Observations

Taking into account the abusive character of the underlying ESOP arrangement in *Yarish*, it is not surprising that the Tax Court reached the result that it did and required Yarish to include the entire amount of his benefit in income for 2004, since any other conclusion would have left Yarish with something in the nature of a tax windfall. The case may also serve as a reminder of the general reluctance of the courts to rule in a taxpayer's favor based on a technical argument where such a ruling would be inconsistent with the result that appears most appropriate and fair based on all the facts and circumstances.

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[1] See Rev. Proc. 92-64, 1992-2 C.B. 422, and Rev. Proc. 92-65, 1992-2 C.B. 428.
[2] See Reg. § 1.402(b)-1(b)(6).
[3] See Reg. § 1.402(b)-1(c)(1).
[4] 139 T.C. No. 11 (2012)

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