PART V: EDUCATIONAL BENEFIT TRUSTS

In General

3598. What are the tax consequences of an educational benefit trust?

At one time, educational benefit trusts promised to provide funds to pay certain educational costs on a tax favored basis. IRC Regulation 1.962-1 confirmed, however, that these benefits were taxed to employees when paid as compensation. Where employer contributions to an educational benefit trust are related to an employee's service, they are taxed as compensation to the employee when they are either paid to or for the benefit of their children or no longer are subject to a substantial risk of forfeiture.[1]

Amounts paid to provide benefits to children of stockholder-employees generally are treated as compensation to the employees, not dividends, where the plan is adopted for business reasons in an effort to attract and retain employees.[2]

Where a bona fide debtor-creditor relationship is not intended for funds advanced to employees for this purpose, the amounts are treated as compensation even though called "loans."[3]

IRC Sections 419 and 419A generally apply to post-1985 contributions to an educational benefit trust. Prior to that time, there was some controversy regarding the timing of the employer's deduction. For years, the position of the IRS was that benefits provided under an educational benefit trust related to the employee's service constituted a deferral of compensation and, therefore, the employer's deductions should be taken when the benefits are paid out under IRC Section 404(a)(5).[4] The IRS has since privately ruled that an educational benefit trust was a "welfare benefit fund," and that the deduction of contributions is controlled by IRC Section 419.[5]

Educational benefit trusts cannot take advantage of the (limited) immediate deductions for advance funding under the general rule of IRC Section 419 because they do not have "qualified asset accounts."[6] Thus, an employer's deduction generally is limited to the amount includable in income by employees that year, minus the trust's after-tax income.

The general rule of IRC Section 419(b), which limits the deduction of welfare benefit fund contributions to the fund's "qualified cost," does not apply to contributions to a collectively

1. *Grant-Jacoby, Inc. v. Comm.*, 73 TC 700 (1980); *Citrus Orthopedic Medical Group, Inc. v. Comm.*, 72 TC 461 (1979); *Armantrout v. Comm.*, 67 TC 996 (1977), *aff'd*, 570 F.2d 210 (7th Cir. 1978); Treas. Reg. §1.83-3(c)(4), Ex. 2; Rev. Rul. 75-448, 1975-2 CB 55; Let. Rul. 8535002. See also *Wheelerv. U.S.*, 768 F.2d 1333 (Fed. Cir. 1985).
2. *Grant-Jacoby, Inc. v. Comm.*, supra.
3. *Saunders v. Comm.*, TC Memo 1982-655, *aff'd*, 720 F.2d 871, 83-2 USTC ¶88,609 (5th Cir. 1983) (overly generous loan forgiveness provisions in plan indicated true loan not intended). See Let. Rul. 8137001.
4. See *Grant-Jacoby, Inc. v. Comm.*, supra; *Citrus Orthopedic Medical Group, Inc. v. Comm.*, supra; Rev. Rul. 75-448, 1975-2 CB 55.
5. Let. Rul. 8737022.
6. IRC Sec. 419A(a).

bargained welfare benefit fund. The IRS has ruled that such contributions could be deducted in the year contributed, provided that they constitute ordinary and necessary expenses.[1] This ruling is questionable, however, because it is based on a temporary regulation (published before the current statutory text) that provides more generous treatment for collectively bargained funds than current law.

For a more detailed treatment of welfare benefit funds, see Q 3969 and Q 3970.

1. See Let. Rul. 9510048.