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# Editor's Note

A 2021 decision by a U.S. District Court provided that the COVID-19 pandemic and a business downturn are not necessarily an excuse for not paying benefits to participants in a non-qualified deferred compensation plan.

In *Melvin Clark, et al., v. Stanley Furniture Company, LLC, et al.*, 2021 BL 395507, W.D. Va., 4:20-cv-00063,October 14, 2021, Stanley Furniture Company was found liable under the Employee Retirement Income Security Act of 1974, as amended (ERISA), for missed deferred compensation payments to the retired executives by the U.S. District Court for the Western District of Virginia. The court rejected the arguments made by Stanley Furniture Company that a business downturn compounded by the COVID-19 pandemic made it impossible to make the required payments and that its deferred compensation plan included an exception for such circumstances.

Decades ago, Stanley Furniture Company, LLC (SFC) allowed executives to defer compensation until their later working years, or even retirement. The deferrals accrued high interest on beneficial tax terms.

But the furniture business fell on hard times (at least in the United States), and the COVID-19 pandemic only compounded the economic problems. Even before the pandemic started, SFC had missed some of its scheduled deferred compensation payments. And, once COVID-19 lockdowns began, Stone & Leigh, LLC (S&L), which owned an interest in SFC and was responsible for some of those deferred compensation payments, began missing payments too. The plaintiffs, all retired SFC executives, understandably asked SFC to resume payments. When these efforts proved futile, the plaintiffs brought this suit under ERISA, formally demanding their missed benefits payments, declaratory judgments ensuring their future payments, prejudgment interest, and attorney's fees.

AQ: Except in rare cases, sentences should not start with But or And. Please check the sentence "But the furniture business fell . . ." and amend. Also check in other places as well.

The matter was before the court on the plaintiffs' motion for summary judgment. The court granted that motion.

The plaintiffs were all retired SFC business executives. During their years working at SFC, each individual plaintiff deferred some compensation in exchange for cash benefit payments which would be paid years, or even decades, later. In 2018, S&L purchased several assets from SFC and, as part of that deal, accepted some of SFC's deferred compensation obligations.

Since then, SFC and S&L have administered the contested deferred compensation plans, SFC administered the Stanley Interiors Corporation Deferred Capital Enhancement Plan (the "DCP") (together, the "Stanley Defendants"), and S&L administered the Supplemental Retirement Plan of Stanley Furniture Company, Inc. (the "SERP") (together, the "S&L Defendants").

The parties stipulated to several key facts. First, there was no dispute that each plaintiff was entitled to deferred compensation under the DCP and/or the SERP. Second, at the time the plaintiffs moved for summary judgment, the parties agreed on how much each plan owed its respective beneficiaries. SFC began to miss deferred compensation payments in 2019, paid each of the Stanley plaintiffs only $500 in 2020, and had not made a payment in 2021. The parties agreed on the amounts owed to each plaintiff by the DCP and the SERP.

The court focused on two issues. First, the Stanley Defendants argued that the plain language of the plan empowered them to limit benefits during financially stressful times; in summary, they contended the plans themselves contemplated the non-payment. Second, all of the defendants argued that the COVID-19 pandemic made it impossible for them to perform their contractual obligations under the plans. As a result, they maintained that their performance could be excused. The plaintiffs contested both positions and sought damages equal to what they were owed, plus prejudgment interest and attorneys' fees, as well as declaratory judgments establishing their entitlement to future benefits.

The parties agreed that ERISA covered the DCP and the SERP, courts construed ERISA plans "according to the ordinary principles of contract law." *M & G Polymers USA, LLC v. Thackett*, 574 U.S. 427, 435 (2015). The court has to first look to the contract's language; if the language is "clear and unambiguous, [the contract's] meaning is to be ascertained in accordance with its plainly expressed intent." *Id.* If an ERISA plan is ambiguous, courts construe the plan against the drafter and in line with the insured's reasonable expectations. *Jenkins v. Montgomery Indus., Inc.*, 77 F.3d 740, 743 (4th Cir. 1996).

The DCP explained how future employee benefits were calculated and included a plan summary. The Stanley Defendants cited three different sentences from the plan and its attached summary to support their position that they had no obligation to pay the Stanley plaintiffs' benefits, given their recent business struggles. Under the heading "Unsecured General Creditor[s]," the DCP provided that:

> Participants and their beneficiaries, heirs, successors and assigns shall have no legal or equitable rights, interests or

> other claims in any property or assets of the Employer… . Employer's obligation under the Plan shall be that of an unfunded and unsecured promise of Employer to pay money in the future.

The court said that, in other words, in the event of a bankruptcy, the plan beneficiaries would receive a portion of their expected deferred compensation only if the Stanley Defendants could satisfy their secured creditors first. But the statement that plan beneficiaries "shall have no legal or equitable rights, interests, or other claims in any property or assets of the Employer" did not mean that an economic downturn suspended the Stanley Defendants' deferred compensation obligations. It simply provided that the plan beneficiaries were unsecured creditors of the company, and it described their attendant priority in bankruptcy proceedings.

The court said that the other excerpts relied on by the Stanley Defendants came from the plan summary. As an initial matter, that summary advised that, "if there is any discrepancy between this summary and the plan document, your right to benefits shall be governed by the plan document." Thus, to the extent that the defendants argued that the summary diminished the plaintiffs' rights to deferred compensation, as established by the DCP's terms—and, in turn, the defendants' obligation to provide deferred compensation—that position was belied by the plain and unambiguous terms of the summary itself.

But even on their own terms, the summary excerpts did not reach economic downturns. The first statement, like the statement cribbed from the plan, contemplated bankruptcy. Under a heading reading "UNSECURED CREDITOR," the summary explained that "[a participant in a non-qualified deferred compensation plan is an unsecured creditor of the Company. Thus, in the unlikely event of a financial disaster to the Company, your deferred compensation may be lost." This language simply reinforced the beneficiaries' status as unsecured creditors and did not reach the situation in this case.

AQ: please provide the missing closing bracket in "[a participant in a non-qualified . . ."

Third, the Stanley Defendants pointed to language that advised plan beneficiaries that their benefits "cannot be guaranteed." But this excerpt, also from the plan summary and not the DCP, anticipated changes to tax laws. In response to the posed question "ARE THESE BENEFITS GUARANTEED?" the first full paragraph explained, in relevant part:

> The Company is only able to offer these exceptional rates of return because of its ability to realize favorable investment

> returns under the existing tax laws. The company reserves the right to reduce the rates of return in the event that tax laws change in the future. Thus, the benefits described above cannot be guaranteed.

The court said that, although the Stanley Defendants would like the court to read the last sentence divorced from the paragraph that contained it, it was clear that this language referred to changes in tax policy, not an unfortunate economic environment. Cherry-picking language and divorcing it from its obvious intent violated basic norms of contract interpretation. *See Brucker v. Taylor*, No. 1:16-cv-01414, 2017 WL11506333, at *5 (E.D. Va. Mar. 28, 2017) ("[C]ontracts must be construed as a whole.") (quoting *TM Delmarva Power, LLC v. NCP of Va., LLC*, 557 S.E.2d 199, 200 (Va. 2002)).

The statements the Stanley Defendants relied on did not contemplate the kind of temporary economic downturn SFC experienced during the COVID-19 pandemic. They were concerned with bankruptcy and tax issues. But even if language in the plan summary conflicted with the DCP's terms, the DCP would control. And the DCP required that the beneficiaries be paid what they were owed.

The court said that, for these reasons, the Stanley Defendants' arguments about the DCP's plain language failed.

The court said that both the Stanley Defendants and the S&L Defendants raised the impossibility doctrine to excuse their failure to meet their deferred compensation obligations. "To prove the defense of impossibility of performance, a defendant must prove: (1) the unexpected occurrence of an intervening act; (2) such occurrence was of such a character that its non-occurrence was a basic assumption of the agreement of the parties; and (3) the occurrence made performance impracticable." *CMA CGM S.A. v. Leader Int'l Express Corp.*, 474 F. Supp. 3d 807, 817 (E.D. Va. 2020) (citing *Fla. Power & Light Co. v. Westinghouse Elec. Corp.*, 826 F.2d 239, 264 (4th Cir. 1987)). "In considering the non-occurrence of an event, the question is whether the event is 'one which the parties could reasonably be thought to have foreseen as a real possibility which could affect performance.'" *Id.* (quoting *Opera Co. of Boston v. Wolf Trap Found.*, 817 F.2d 1094, 1102 (4th Cir. 1987)). The court said that, despite this general language, courts usually limit impossibility to three specific circumstances: (1) the supervening death or incapacity of a person necessary for performance; (2) the supervening destruction of a specific thing necessary for performance; and (3) the supervening prohibition or prevention by law. Restatement (Second) of Contracts § 261 cmt. a

(Am. Law. Inst. 1981). The court said that only the third circumstance was arguably applicable in this case.

Impossibility due to a supervening government order usually applied if a government act directs or prohibits certain conduct. "[T]he fact that it is still possible for a party to perform if he is willing to break the law and risk the consequences does not bar him from claiming discharge." *See id*. For example, an order decriminalizing furniture sales would make performance legally impossible. Alternatively, the government might instruct merchants to sell their wares to the government, forcing them to breach pre-existing contracts. *See id.* § 264 ill. 6. Either way, the Restatement contemplated more than a "[g]overnmental action that has the indirect effect of making performance more burdensome." *See id.* § 264 cmt. b.

The defendants argued that Virginia's shut-down orders in response to COVID-19 limited their business opportunities and made performance of their deferred compensation obligations impossible. On March 12, 2020, the Honorable Ralph S. Northam, Governor of Virginia, declared a state of emergency as a result of the COVID-19 outbreak. Va. Exec. Order No. 51 (Mar. 12, 2020). For at least a portion of the pre-vaccine pandemic, Virginia required all non-essential brick-and-mortar retailers to "limit all in-person shopping to no more than 10 patrons per establishment." Va. Second Am. Exec. Order No. 52 (May 4, 2020). These orders coincided with dramatic cost cutting at SFC, which shut down all of its U.S. operations and either furloughed or laid off its entire workforce as Virginia and the country locked down.

Rather than commandeering the defendants' inventory or outlawing furniture sales altogether, Virginia's orders only made performance more difficult. But courts have applied a general rule that, "[e]conomic hardship, even to the extent of bankruptcy or insolvency, does not excuse performance." *Ebert v. Holiday Inn*, 628 F. App'x 21, 23-24 (2d Cir. 2015); *see also Bistro of Kan. City, Mo., LLC v. Kan. City Live Block 125 Retail, LLC*, No. ELH-10-2726, 2013 WL 4431292, at *34 (D. Md. Aug. 16, 2013). This general rule was extended to the COVID-19 pandemic. *See, e.g., Dominion Energy Cove Point LNG, L.P. v. Mattawoman Energy, LLC*, No. 1:2-cv-611, 2020 WL 9260246, at *8 (E.D. Va. Oct. 20, 2020) (rejecting a party's COVID-19-related impossibility defense); *Gap, Inc. v. Ponte Gadea N.Y., LLC,* No. 20-cv-4541, 2021 WL 861121, at *10 (S.D.N.Y. Mar. 8, 2021).

The court said that, for those reasons, there was no genuine dispute of a material fact regarding the impossibility defense. The defense did not apply. The government orders did not make performance

impossible. Therefore, the court granted summary judgment to the plaintiffs on their benefits claims.

The plaintiffs also sought declaratory judgments confirming their rights to deferred compensation payments from each defendant indefinitely.

The Declaratory Judgment Act allowed the court to "declare the rights and other legal relations of an interested party seeking such declaration, whether or not further relief is or could be sought." 28 U.S.C. § 2201(a); *see also* 29 U.S.C. § 1132(a)(1)(B) (ERISA plaintiffs could seek declaratory relief "to clarify [their] rights to future benefits under the terms of the plan"). Declaratory relief "is appropriate when the judgment will serve a useful purpose in clarifying and settling the legal relations in issue, and when it will terminate and afford relief from the uncertainty, insecurity, and controversy giving rise to the proceeding." *Penn-America Ins. Co. v. Coffey*, 368 F.3d 409, 412 (4th Cir. 2004). The court exercised discretion when deciding whether to grant declaratory relief. *New Wellington Fin. Corp. v. Flagship Resort Dev. Corp.*, 416 F.2d 290, 297 (4th Cir. 2005).

The S&L plaintiffs asserted that they needed the declaratory judgments to "clarify[] their rights to future monthly benefits for the amounts undisputed by the SERP Defendants." The S&L Defendants made three arguments in response. First, they contended that the SERP itself was subject to amendment and termination. Either method would have ended any future payment of the plan's "conditional" benefits. The court said that, because those future payments were voidable, a declaratory judgment concluding otherwise would be inappropriate. Next, they argued that when S&L purchased SFC's assets, the relevant Asset Purchase Agreement (APA) capped S&L's liability under the SERP. Finally, they argued that there was no need for a declaratory judgment because the SERP's terms were clear, both parties agreed to the schedule on which benefits accrued to the plaintiffs, and—given S&L's recent payment, the SERP plan was more or less current in its obligations to the plaintiffs. In short, there was no confusion, ambiguity, or uncertainty for a declaratory judgment to resolve.

The court disagreed. This was an appropriate case for declaratory relief. The SERP provided the context, the first two arguments were belied by the SERP's plain terms. Turning first to the amendment and termination provisions, the SERP stated:

> Amendment of Plan – The Board reserves the right at any time and from time to time retroactively if deemed necessary or appropriate to amend or modify, in whole or in part, any

> or all of the provisions of the Plan; provided that *no such modification or amendment shall adversely affect the right and benefits accrued by Participants under the Plan prior to the effective date of such amendment or modification.*
>
> Termination of Plan – The Board may terminate the Plan for any reason or no reason at any time provided *that such termination shall not adversely affect the right and benefits accrued by Participants under the Plan prior to the effective date of such termination.*

This language did not permit the S&L Defendants to abrogate committed compensation, and it did not permit the S&L Defendants to cancel or reduce the S&L plaintiffs' deferred compensation payments. It explicitly said that, whatever the S&L Defendants did, they could *not* do that.

The S&L Defendants further objected to the declaratory judgment on the grounds that they capped the amount of deferred compensation for which they were responsible as a condition of their assumption of the obligations under the SERP as part of the APA. The purchase agreement confirmed their intention. S&L and SFC agreed that S&L would assume all of SFC's liabilities and obligations under the SERP "as they are payable under such plan and that do not exceed in the aggregate $1,779,939."

The court said that argument, however, did not affect the plaintiff's *entitlement* to continued SERP benefits; rather, it only addressed whether SFC or S&L was the party *responsible* for paying those benefits. As an initial matter, the court was dubious that a company could jilt the beneficiaries of its ERISA plan by later capping a successor in interest's liability in a separate contractual agreement. One party cannot unilaterally modify a contract. *See, e.g., Brown v. Brown*, 674 S.E. 2d 597, 599 (Va. Ct. App. 2009); *Edwards v. JPMorgan Chase Bank*, *N.A.*, No. 1:20-cv-128, 2020 WL 1814423 at *2 (M.D.N.C. Apr. 9, 2020) (applying North Carolina law).

The court said that, in any event, the record indicated that the plaintiffs were not close to hitting S&L's purported cap. The briefs did not address how much the SERP paid out since S&L took it over, but the record indicated that the S&L plaintiffs were collectively due about $6,300 each month, and all the SERP plan's beneficiaries cumulatively received around $13,000. S&L was responsible for the SERP since approximately September 2018—around 36 months. That suggested that S&L's expenditures to date were approximately $468,000. Whatever the exact number, the important thing was that

the S&L plaintiffs were not in danger of hitting the purported cap anytime soon. Because the S&L Defendants did not reach the cap on their obligations, this argument did not excuse their non-compliance with the terms of the SERP.

Finally, the S&L Defendants argued that no useful purpose would be served by a declaratory judgment. The parties had a contract for over three years and S&L was up to date on its obligations.

The court said that argument elided two problems. First, the SERP argued that S&L plaintiffs did not need a declaratory judgment despite avoiding its contractual obligations for more than a year—from April 2020 to September 2021. While the S&L plaintiffs did not "need" a declaration of their rights, the S&L Defendants, given the events of the past two years and the positions taken during this litigation, apparently did need the court to clarify their obligations. Accordingly, because it would prevent the defendants from raising the same, or similar, arguments in the future to avoid making additional payments, the court found that a declaratory judgment was warranted.

The court said that, second, ERISA was a remedial statute designed, in part, to protect retirees and older workers. *Massachusetts v. Morash*, 490 U.S. 107, 112 (1989). ERISA explicitly makes declaratory relief available to plaintiffs in the S&L plaintiffs' situation. 29 U.S.C. § 1132(a)(1)(B). Declaratory relief would protect S&L plaintiffs from future delays in payment and prevent S&L from arguing that those payments were conditional, furthering ERISA's remedial purpose.

The court said that the S&L plaintiffs were entitled to a declaratory judgment for their deferred compensation payments under the SERP's terms.

The plaintiffs requested that the court award prejudgment interest on their past due benefits, "ERISA does not specifically provide for pre-judgment interest, and absent a statutory mandate the award of pre-judgment interest is discretionary with the trial court." *Quesinberry v. Life Ins. Co. of N. Am.*, 987 F.2d 1017, 1030 (4th Cir. 1993) (en banc). "The rate of pre-judgment interest for cases involving federal questions is a matter left to the discretion of the district court." *Nahigian v. Juno-Loudon, LLC*, 667 F.3d 579 (4th Cir. 2012). "The essential rationale for awarding prejudgment interest is to ensure that an injured party is fully compensated for its loss." *Roark v. Universal Fibers, Inc.*, No. 1:16-cv-40, 2017 WL 19091977, at *6 (W.D. Va. May 9, 2017) (*quoting City of Milwaukee v. Cement Div., Nat'l Gypsum Co.*, 515 U.S. 189, 195 (1995). The plaintiffs persuasively noted at the hearing on this motion that prejudgment interest was appropriate because they had deferred income precisely to take advantage of interest rates in the meantime.

The DCP explicitly stated that Virginia law governed its construction. The SERP was enacted in Virginia, which meant that it was also governed by Virginia law. *See Klein v. Verizon Commc'ns, Inc.*, 674 F. App'x 304, 307-08 (4th Cir. 2017) (per curiam). Virginia set its prejudgment interest rate at 6 percent. Va. Code. Ann. §§ 6.2-302; 8.01-382. The court frequently awarded ERISA plaintiffs prejudgment interest at that rate, *see, e.g., Roark*, 2017 WL 1901977, at *6; *McIntyre v Aetna Life Ins. Co.*, 581 F.Supp.2d 749, 762 (W.D. Va. 2008), and the Fourth Circuit endorsed that practice, *see Quesinberry*, 987 F.2d at 1030-31 (affirming an award of prejudgment interest at Virginia's statutory rate to an ERISA plaintiff). The court sought no reason to test-drive a new standard in this case. The court granted the plaintiffs' prejudgment interest at Virginia's 6 percent rate.

The court said that ERISA gave district courts discretion to award reasonable attorneys' fees. *See* 29 U.S.C. § 1132(g)(1); *Plasterers' Loc. Union No. 96 Pension Plan v. Pepper*, 663 F.3d 210, 221-22 (4th Cir. 2011). The court had to first determine whether either party was eligible for an award of attorneys' fees under *Hardt v. Reliance Standard Life Insurance Co.*, 560 U.S. 242 (2010). *Pepper*, 663 F.3d at 223. Then, if a party was eligible, the court had to analyze the *Quesinberry* factors to determine whether an award was appropriate. *Id.*

"[A] fees claimant must show some degree of success on the merits before a court may award attorney's fees under § 1132(g)(1)." *Hardt*, 560 U.S. at 255. In this case, the plaintiffs won a judgment worth more than $600,000, two declaratory judgments, and prejudgment interest. Thus, the court concluded that they secured "some degree of success on the merits." *See Williams v. Metro. Life Ins. Co.*, 609 F.3d 622, 634-35 (4th Cir. 2010) (affirming the district court's determination that a plaintiff who had won summary judgment was eligible for attorney's fees under *Hardt*).

Although the plaintiffs were eligible for attorney's fees, the court retained discretion to deny such an award. *See id*. at 635-36. The court had to analyze the *Quesinberry* factors to determine whether such an award was warranted. Those factor were:

(1) the degree of opposing parties' culpability or bad faith;

(2) the ability of opposing parties to satisfy an award of attorney' fees;

(3) whether an award of attorneys' fees against the opposing parties would deter other persons acting under similar circumstances;

(4) whether the parties requesting attorneys' fees sought to benefit all participants and beneficiaries of a ERISA plan or to resolve a significant legal question regarding ERISA itself; and

(5) the relative merits of the parties' positions.

*Id*. (*quoting Quesinberry*, 987 F.2d at 1029). These factors were "general guidelines"; they did not set out a "rigid test." *Pepper*, 663 F.3d at 223 (*quoting Williams*, 609 F.3d at 636).

The parties disputed each factor. The court found that four of the five *Quesinberry* factors weighed in favor of the defendants and that attorneys' fees were not warranted. The court addressed each factor specifically.

1. *Bad Faith*. The court said that a lack of bad faith cuts in the defendants' favor. S&L's recent payment, for obvious reasons, evinced good faith. Although the Stanley Defendants did not make any payment since a partial payment in August 2020. But in light of their financial stress, non-payment, by itself, was insufficient for the court to find that they acted in bad faith. Although business was struggling, SFC reiterated in the deposition of its corporate representative that resuming full operations was the only way that the Stanley plaintiffs could end up being paid in full. In the meantime, SFC negotiated in good faith to settle this case, which would have given the Stanley Defendants something—not everything they were owed, but likely more than they would have received in a bankruptcy. The court found that the S&L Defendants and the Stanley Defendants, although litigating zealously, did not act in bad faith.

2. *Ability to Pay*. The court said that, ability to pay also favored the defendants. At the end of the last year, both the defendants were flirting with insolvency. During discovery, each company stated under oath that it had recently contemplated bankruptcy. Their financial statements confirmed this precarity. SFC had only $23,009 in cash on hand in January 2020. That is 26 times less than what it owed the plaintiffs. And it's *517 times* less than SFC's liabilities at that time. The court said that, given these obligations, SFC was not in a financial position to make the SFC plaintiffs whole, much less satisfy an additional award for attorneys' fees.

The court said that, at the hearing on their motion for summary judgment, the plaintiffs pushed back on this argument. They noted that SFC was distressed for years, but that wealthy firms invested in SFC to keep it afloat. The court said that, given these apparent lifelines, it was clear that SFC could pay the plaintiffs. But the test was not whether companies with an interest in the opposing party could

afford to pay a plaintiff's attorneys' fees. Nor should it be; that SFC avoided bankruptcy only because its investors kept it on life support undercut the argument that SFC itself could afford to pay an award of attorneys' fees.

The court said that this factor was a little more complicated as to S&L, which made (or came close to making) the S&L plaintiffs whole. But, aware that the payment to the S&L plaintiffs came on the eve of a summary judgment hearing, the court was unwilling to find that S&L had the ability to pay a grant of attorneys' fees. At the end of last year, S&L had $19,374 cash on hand. But it also owed its creditors $974,793. And S&L said that this payment required a plan beneficiary to further delay his own payments; so, S&L could catch up on its payments to the other beneficiaries. The company deserved some discretion over which of its obligations were most critical as it returns to profitability. The court, therefore, found that S&L could not satisfy an award of attorneys' fees.

3. *General Deterrence.* The court said that the third factor was general deterrence. The court had to decide whether an award of attorneys' fees would deter companies similarly situated to S&L and Stanley from withholding deferred compensation payments. The court concluded it would not. Again, S&L and SFC were distressed companies. Such companies had to make difficult decisions about which creditors to pay, whether to pay them in full, and in what order. The plaintiffs were no more entitled to their deferred compensation than other creditors were entitled to their payments. The court found that an award of attorneys' fees would not have a beneficial, general-deterrent effect. *Compare DuPerry v. Life Ins. Co. of N. Am.*, 632 F.3d 860, 877 (4th Cir. 2011) (after a plaintiff successfully overturned the denial of his disability claim, the court found that an award of attorneys' fees would deter similar denials).

4. *Significance.* The court said the fourth factor, broadly speaking, addressed the significance of a particular ERISA case, and it gauged significance in two ways. First, did the plaintiffs represent every participant in the plan; and second, were they litigating a significant legal question regarding ERISA? Neither condition was met here. The parties agreed that some DCP beneficiaries and some SERP beneficiaries were not plaintiffs. Nor did the plaintiffs' case involve a novel or complex question about ERISA. The plaintiffs were entitled to benefits under the plain and unambiguous terms of the plan, and the plaintiffs' counsel successfully vindicated that position at summary judgment. Although the impossibility doctrine's applicability to ERISA plans remained unsettled, the *defendants* raised that argument, not the plaintiffs. The court said that the defense

failed, so the question of whether impossibility was available to the defendants was not determinative in this case.

5. *Relative Merits*. The court said that only the relative merits of the parties' positions weighed in the plaintiffs' favor. The plaintiffs won more than $600,000, two declaratory judgments, and prejudgment interest; the merits overwhelmingly favored them. *See Williams*, 609 F.3d at 634-35.

The court determined that, on balance, the *Quesinberry* factors favored the defendants. The court denied the plaintiffs request for attorneys' fees.

Bruce J. McNeil, Esq.
*Editor-in-Chief*

# Non-qualified Deferred Compensation—Accounting Treatment and Income Statement Geography

**BY ERIC A. KEENER, FSA, EA AND R. LEE NUNN, CPA**

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## INTRODUCTION

Historically, the accounting literature under U.S. GAAP has given little direct guidance on how to account for certain non-qualified deferred compensation (NQDC) programs. While many employers have accounted for such programs using a simplified approach, some auditors have begun to reconsider the appropriate accounting treatment in recent years. This article explores the historically prevalent approach and the implications of potential alternatives. In the context of this article, the term NQDC refers to an ERISA top hat plan with multiple participants. Notional accounts for individual participants increase or decrease based on hypothetical investment returns. The principal amounts consist of elective deferrals, employer money (matching or discretionary), or both. The form of payment is limited to installments or lump sums. There are no life annuity payouts.

## BACKGROUND: TRADITIONAL ACCOUNTING FOR NQDC

In practice, many employers have accounted for NQDC programs by establishing a balance sheet liability equal to the sum

of participants' notional account balances. Under their approach, there is no projection of future benefit payments or discounting to the balance sheet date. Forfeitures (if any) are recognized as they occur. An annual benefit expense is recognized in operating income; this expense is equal to

- the change in liability from the prior year-end to the current year-end, plus

- any benefits paid from the company's assets[1] during the current year.

Market losses (i.e., negative investment returns on notional accounts) would reduce the annual expense for the plan, while market gains would increase the annual expense for the plan. Under this approach, companies make no distinction among the individual components of expense (e.g., elective deferrals, employer notional contributions, or investment gains/losses on notional account balances), and none of the expense flows through other comprehensive income (OCI). There are no footnote disclosure requirements. This approach is consistent with accounting for compensation programs under Accounting Standards Codification (ASC) Topic 710-10.

## WHAT HAS CHANGED?

In recent years, some accounting professionals have advocated reporting top hat plans (as distinct from individual contracts or arrangements) under ASC 715-30 rather than ASC 710-10. The recent attention toward ASC 715-30 in this context may be driven by an increased focus on income statement geography (discussed below). Accounting Standards Update (ASU) 2017-07 changed the income statement geography for plans accounted for under ASC 715 by including only current year service cost in operating income (if an operating income measure is presented). The other components of net periodic benefit cost are now shown outside of income from operations. If NQDC were reported under ASC 715-30, the net periodic benefit cost of NQDC reflected in operating income would be limited to the service cost (presumably, elective deferrals and employer contributions). Other components of net periodic benefit cost (e.g., income statement recognition of investment gains/losses on notional accounts) would be presented outside income from operations.

## WHAT IS INCOME STATEMENT GEOGRAPHY?

Income statement geography refers to which line(s) of the income statement reflect(s) the income, expense, gain, or loss for a transaction. In the case of NQDC, the income statement would reflect the benefit expense, including any related notional investment gains or losses. The benefit expense's location within the income statement depends on whether the arrangement falls within the scope of ASC 710-10 or ASC 715-30. Under ASC 710-10, the benefit expense would be included in operating income. Under ASC 715-30, the benefit expense would be disaggregated; only the current year elective deferrals and employer contributions would be included in operating income, and other components of net periodic benefit cost would be shown outside of income from operations (such as in non-operating income or OCI). Note that a gain for the participant is a loss for the employer. Investment income from assets earmarked to support NQDC, such as mutual funds or corporate-owned life insurance (COLI), creates a non-operating gain or loss. Reporting benefit gains and losses in operating income while reporting investment gains and losses in non-operating income results in an accounting mismatch.

## WHY DOES INCOME STATEMENT GEOGRAPHY MATTER?

Operating income is a key measure of financial performance because it focuses on what management controls. For example, management has greater control over revenue and operating expenses than it does over the financial markets. As noted earlier, many companies report NQDC in a manner consistent with ASC 710-10. As a result, bull markets erode operating income, since investment gains credited to participants' notional accounts result in higher benefit expense. All components of benefit expense, including investment gains/losses on notional account balances, are included as compensation expense in operating income. Conversely, bear markets increase operating income, since investment losses charged to participants' notional accounts result in lower benefit expense.

Because companies often report investment gains and losses in non-operating income, financing an NQDC arrangement is ineffective in limiting the volatility of operating income under the ASC 710-10 approach. Investment gains and losses do help to reduce volatility in EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) and pre-tax income. However, the deterioration of operating income in bull markets is a concern for many companies.

Hedging the notional account balance liability with derivatives (e.g., total return swaps) rather than mutual funds or COLI would resolve this income statement geography mismatch[2]; however, many companies choose not to hedge with derivatives.

## WHY ISN'T NQDC CONSIDERED A DEFINED CONTRIBUTION PLAN FOR ACCOUNTING PURPOSES?

If NQDC fell within the scope of ASC 715-70, Compensation—Retirement Benefits—Defined Contribution Plans, income statement geography would not be an issue. The market-driven increases in account balances would disappear not only from operating income, but also from the income statement as a whole. Furthermore, the balances would not appear as a liability on the employer's balance sheet (though there could be a balance sheet liability for any employer contributions that have been earned by employees but not yet made to employees' accounts). Unfortunately, such an accounting treatment is generally limited to qualified plans such as Internal Revenue Code (Code) Section 401(k) and 403(b) plans. NQDC does not qualify for this accounting treatment, because ASC 715-70 requires funded individual accounts rather than notional accounts. NQDC is a general obligation of the company. Any assets earmarked to cover plan benefits (including rabbi trust assets) are considered available to general creditors for both income tax and ERISA purposes.

## IF NOT A DEFINED CONTRIBUTION PLAN, WHAT IS IT?

By process of elimination, NQDC is either a defined benefit plan under ASC 715-30, or not a plan at all, but rather an individual deferred compensation arrangement under ASC 710-10. U.S. GAAP does not define individual arrangements or plans. Even so, the term "plan" implies standardization of certain provisions for all participants, even when some of the provisions feature a menu of choices (e.g., number of installments for payout or a choice among notional investment funds). The use of written plan documents with standardized provisions matters even more under Code Section 409A because variations increase the risk of operational errors in the administration of the benefit (and the potential tax penalties for such errors under Code Section 409A). Limiting eligibility to employees approved by a board or compensation committee would not seem to preclude the existence of a plan for those who do participate. For large employers, individual "one-off" arrangements are unusual.

The guidance in ASC 710-10 emphasizes the individualized nature of arrangements within its scope. For example, ASC 710-10 applies to "deferred compensation or employee benefit arrangements" that are "contracts accounted for individually."[3] Likewise, ASC 710-10 does not apply to "individual deferred compensation contracts that are addressed by Subtopics 715-30 and 715-60, if those contracts, taken together, are equivalent to a defined benefit pension plan or a defined benefit other postretirement benefit plan, respectively."[4] Example 3 in ASC 710-10-55-7 describes "individual contracts with specific terms determined on an individual-by-individual basis" and goes on to contrast the contracts for two different employees. One employee receives a lump sum that is earned prospectively whereas the other is immediately vested in a lifetime annuity. Differences in time and form of payment are common within a plan, but differences in vesting provisions go beyond time and form of payment. This example is consistent with limiting the scope of ASC 710-10 to individual contracts and does not necessarily support the inclusion of highly standardized arrangements in the scope of ASC 710-10.

ASC 710-10 does confuse the distinction between individual arrangements and plans; it uses the term "plan" to describe an arrangement that allows participants to allocate account balances among notional funds (other than company stock), pays benefits in cash, and is financed with a rabbi trust.[5] Changes in the "fair value of the amount owed to the employee" are reflected both in the deferred compensation obligation and compensation cost.[6] A rabbi trust finances the arrangement, and the rabbi trust assets are recorded under the guidance applicable to the particular asset.[7] Despite the widespread application of this method of accounting for NQDC plans, the use of the term "plan" appears to conflict with ASC 710-10-05-6, which limits the scope of ASC 710-10 to individual employment contracts and not pension plans.

By process of elimination, ASC 715-30, Defined Benefit Plans—Pension, may be the authority for accounting for NQDC plans (but not individual arrangements). ASC 715-30 is more commonly understood as applying to "true" pension plans such as final average pay and cash balance plans. Applying ASC 715-30 to NQDC raises several issues, as discussed below.

## HOW WOULD A CHANGE FROM ASC 710-10 TO ASC 715-30 AFFECT ACCOUNTING FOR NQDC PLANS?

Under the ASC 710-10 methodology used by many employers, the entire net benefit cost is included in operating income. As noted

earlier, this can create an income statement mismatch between gains/losses on notional accounts and gains/losses on related investments intended to mirror the liability. ASC 715-30 allows both gain/losses on notional accounts and gains/losses on plan assets to be reflected in non-operating income; however, investments associated with nonqualified plans are not considered plan assets because they are available to corporate creditors.[8] Another change would be in the recognition of forfeitures. Under the ASC 710-10 methodology, most companies expense the entire employer notional contribution and recognize forfeitures as they occur, whereas ASC 715-30 would generally require a turnover assumption to reflect anticipated forfeitures in the benefit liability. Finally, disclosure requirements differ. There are generally no footnote disclosure requirements under ASC 710-10, while ASC 715-30 accounting would require specific footnote disclosures for material plans.

## ISSUES TO BE ADDRESSED UNDER ASC 715-30 ACCOUNTING

If NQDC is to be accounted for under ASC 715-30, several issues need to be addressed. These issues include how the projected benefit obligation (PBO) is measured, whether gains/losses flow through net income (versus OCI), income statement geography of the components of the benefit expense, and disclosure.

### ASC 715-30—How is the PBO Measured?

> The PBO is the "actuarial present value as of a date of all benefits attributed by the pension benefit formula to employee service rendered before that date." For a traditional defined benefit plan, ASC 715-30 describes the discount rate as the result of a portfolio of "high-quality fixed-income investments" with proceeds at maturity that match the expected pattern of benefits.[9] However, an employer that sponsors an NQDC plan wouldn't buy bonds to match the cash flows. Instead, an employer would buy the investments used to measure the notional accounts. Doing so would allow the employer to have an asset that could be liquidated to match the amount and timing of benefit payments, regardless of the amount and timing of those benefit payments. The sufficiency of the asset ignores income taxation of the investment income, but income tax accounting is separate from benefit accounting. For vested

account balances, the PBO should equal the notional account balance, which is consistent with the settlement concept under ASC 715-30. For non-vested account balances, a turnover decrement would estimate the effect of forfeitures so that the PBO would reflect the probability of payment.[10]

## ASC 715-30—Gains and Losses

Gains or losses represent the change in the value of the PBO resulting from experience different from that assumed or from a change in actuarial assumptions. In NQDC, gains or losses would include the change in the PBO because of a change in the value of a notional investment, forfeiture experience that differs from the actuarial assumption, and any change in the actuarial assumption on expected forfeitures. Most postretirement benefit plans record gains or losses through OCI and then amortize the accumulated gain or loss outside a 10% corridor through net income as a component of net periodic pension cost.[11] However, a mark-to-market approach with "immediate recognition of gains and losses as a component of net periodic pension cost is permitted if that method is applied consistently and is applied to all gains and losses on both plan assets and obligations."[12]

The requirement of consistent application raises a question: may a company reasonably take a dual approach of recording gains or losses for a traditional pension plan through OCI while using mark-to-market for gains or losses from NQDC? We argue yes, because there are fundamental differences between these two broad categories of compensation—"true" pension plans vs. NQDC. Such an approach would avoid an accounting mismatch between the NQDC benefit expense and the investment gains or losses. All NQDC benefit expense and investment gains or losses would flow through net income as non-operating gains or losses.

For context: *qualified* plans generally hold plan assets, which are restricted to provide for pension benefits.[13] ASC 715 aggregates the gain or loss on *plan* assets with the gain or loss from benefits. Therefore, such plans present

no accounting mismatch. Conversely, assets that finance NQDC, including rabbi trust-owned assets, are not plan assets because they are explicitly available to creditors.[14] Any gain or loss on such assets flows through net income.[15] Avoiding an accounting mismatch in NQDC under ASC 715 requires that *benefit* gains or losses also flow through net income (i.e., a mark-to-market approach) rather than recognition in OCI.

### ASC 715-30—Income Statement Geography

Income statement geography refers to where components of comprehensive income appear in the comprehensive income statement. For net benefit expense, possibilities include compensation expense (a component of operating income), non-operating gain and loss, and OCI. For plans within the scope of ASC 715, ASU 2017-07 requires that the service cost be included in compensation cost (as a component of operating income), whereas other components of net benefit cost must be presented separately and outside income from operations (e.g., non-operating income). By analogy, elective deferrals and employer notional contributions in NQDC represent service cost and should be reflected in operating income. Gains and losses, especially the changes in the value of notional investments, should be shown outside income from operations. Presenting NQDC benefit gains and losses in non-operating income pairs these amounts with gains and losses from funding vehicles such as mutual funds and COLI, which are still the most popular investments used to finance these plans.

### ASC 715-30—Disclosure

Employers presenting NQDC under ASC 715-30 should disclose the following, generally consistent with the disclosure requirements for other defined benefit plans:

- Elective deferrals
- Employer contributions (adjusted for a turnover assumption)

- Gains/losses
- Benefits paid
- Description of notional investment options and distribution options
- Expected benefits in each of the next five years and then the aggregate benefits to be paid in the following five years

## TRANSITION ISSUES

Employers that adopt new plans may be able to adopt ASC 715-30 treatment for NQDC as described above. Employers that want to explore a change from ASC 710-10 to ASC 715-30 face several questions. Is a change from ASC 710-10 to ASC 715-30 accounting required for NQDC? If so, when is such a change required? If not, can a plan sponsor optionally change to ASC 715-30 accounting? Would doing so require a preferability letter from the auditor and retrospective application? Are additional disclosures required in the year of the change? Employers should discuss these issues with their auditors and internal accounting staff.

## INTERNATIONAL FINANCIAL REPORTING STANDARDS

Companies reporting under International Financial Reporting Standards (IFRS) may encounter similar questions regarding the accounting treatment and income statement geography for NQDC. The accounting for employee benefits under IFRS is governed by International Accounting Standard (IAS) 19, which specifies different accounting treatment for postemployment benefits, such as defined benefit pensions, and other long-term employee benefits, such as deferred remuneration. It may be unclear whether NQDC programs should be accounted for as pensions or as deferred remuneration under IAS 19. Furthermore, if NQDC programs are accounted for as pensions, it may be unclear how to determine the value of the defined benefit obligation (DBO). The International Accounting Standards Board (IASB) has discussed whether to provide further guidance on the valuation of pension benefits that depend on the return on a specified pool of assets, and whether the DBO for such benefits should be no greater than the related account balances.[16] Related

issues include whether gains or losses should be included in profit or loss or in OCI. The IASB recently decided to stop work on this project and will consider any further work on pension benefits as part of an agenda consultation.[17]

## SUMMARY

Employers sponsoring NQDC plans and reporting under U.S. GAAP should discuss the potential application of ASC 715-30 to NQDC. Reporting these plans under ASC 715-30 avoids an accounting mismatch between the benefit expense (through operating income) and returns on earmarked investments (through non-operating gains and losses). A transition from ASC 710-10 to ASC 715-30 will complicate the process.

## NOTES

1. Unlike the plan assets of qualified pension plans, assets financing NQDC are general assets, regardless of whether a rabbi trust owns these assets.
2. ASC 815-20-45-1A.
3. ASC 710-10-15-4.
4. ASC 710-10-15-5.
5. ASC 710-10-25-15(d).
6. ASC 710-10-35-4.
7. ASC 710-10-25-18.
8. ASC 715-60-55-27.
9. ASC 715-30-35-43.
10. ASC 715-30-35-1A.
11. ASC 715-30-35-19.
12. ASC 715-30-35-20.
13. ASC 715-30-20.
14. ASC 715-60-55-27.
15. ASC 321-10-35-1.
16. *https://www.ifrs.org/content/dam/ifrs/meetings/2021/october/iasb/ap6-pension-benefits-that-vary-with-asset-returns-additional-information-and-future-direction-of-the-project.pdf*.
17. *https://www.ifrs.org/projects/work-plan/pension-benefits-that-depend-on-asset-returns/*.

# “Hands-On” Strategies for Correcting 409A Operational Failures in Non-qualified Plans

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## INTRODUCTION

Internal Revenue Code Section 409A (409A) is most concerned with the time and form of payment of non-qualified deferrals of income and its taxation. Much of the time and effort to be undertaken by employers involving 409A involves either ensuring that non-qualified deferred compensation payments are timely made or, unfortunately, correcting situations where such payments are either paid too early or paid too late. This article focuses on the correction of 409A operational failures by the end of the second year following the failure.

With certain limited exceptions, the amount and timing of benefit payments must conform to the original schedule specified in the plan or must be consistent with a timely election by the participant. Since non-qualified plans may only affect a small subset of employees, it is not unusual for HR or Benefits staff to inadvertently miss or delay payment dates due to the infrequent nature of these payments. While payroll departments may from time to time fail to process elective deferrals correctly, failing to process distributions is more common. Failing to follow the originally scheduled time and form of payment can cause taxation of the deferrals at the time of failure, aggregation of all similar 409A arrangements payable to the recipient for these purposes, and penalties that include a 20 percent additional tax and a premium interest tax. Indirect costs include legal and consulting

fees, and tax preparation fees for the participant—at the federal, state, and local level. Unfortunately, Internal Revenue Service Notice 2008-113 (Notice 2008-113) makes no exception for inadvertent or unintentional administrative mistakes or failures involving de minimis amounts (although there is a provision for limited amounts). Fortunately, Notice 2008-113 allows varying degrees of relief for certain operational failures corrected by the end of the second taxable year following the taxable year of the failure. This article is intended as a "hands-on" guide to working with Notice 2008-113 when an operational failure is discovered before the end of that second taxable year.

## HOW TO GET STARTED

Before evaluating how best to proceed with a 409A correction, it is important to make certain that you have all the relevant facts. We have seen situations where there was thought to have been an early (or late) deferral or distribution only to discover additional information in support of the payments. Thus, before addressing any needed corrective action, we recommend that the reader consider the following before proceeding:

(i) Have you identified the plan document that would govern the time or form of payment?

(ii) Have there been any amendments to the plan document since it was originally adopted?

(iii) Do any of the payments being made relate to "grandfathered" deferral benefits (benefits earned and vested before January 1, 2005[1]) that would not be subject to 409A?

(iv) Did the participant submit (or change) any deferral or distribution elections concerning plan benefits?

(v) Was the participant an "insider"[2] or "specified employee"[3] within the meaning of 409A?

(vi) Does the participant participate in other non-qualified deferred compensation plans sponsored by the employer?

(vii) What was the amount and nature of the payments that may have been improperly paid or deferred?

## EVEN "RELIEF" CAN SEEM HARSH

Once you have determined that you have an operational error, relief does not mean a "cure" without consequences in the context of Notice 2008-113. Some corrective scenarios impose the 20 percent additional tax on the employee. Some corrective scenarios prohibit crediting interest or notional gains to late payments. Some corrective scenarios require the filing of a corrective Form W-2c for the failure year, which requires an amended individual tax return. Many repayments by the employee to the employer are based on the gross amount paid to the employee even though the original payment received by the employee was net of income tax withholding. Finally, 409A failure notices may need to be filed with both the employer and employee federal income tax returns for the year in which the failure was discovered. The exception is that the employee does not include the notice in his tax return to the extent that the correction is in the same year of the failure.[4]

## NATURE OF RELIEF UNDER NOTICE 2008-113

The various requirements for corrections often cause employers to question the value of the relief. The most important source of relief may be from the 409A aggregation rules (i.e., rules that aggregate similar benefits, such as all 409A non-account balance plans). Absent relief under Notice 2008-113, even an unintentional underpayment of $10 could cause other vested 409A deferrals of the same category to be subject to immediate taxation, the 20 percent additional tax, and premium interest tax. These taxable amounts might include benefits under entirely separate plans that are in the same 409A aggregation category (e.g., non-account balance plans).[5] Under the relief of Notice 2008-113, if available, only the incorrect payments are potentially subject to the 20 percent additional tax, and no amounts are subject to the premium interest tax. Some scenarios neither impose the 20 percent additional tax nor require a corrective Form W-2c or 1040-X.

## ARRANGEMENTS OUTSIDE THE SCOPE OF 409A

The rules surrounding the application of 409A can be quite complex. Some arrangements that might be considered deferred compensation fall outside the scope of 409A. For example, qualified plans such as 401(k) plans and defined benefit plans are not subject to 409A.[6] Likewise, non-discriminatory health savings accounts and certain welfare benefits, the payments from which are available only

on death or disability, are not subject to 409A.[7] Section 457(b) plans, both broad-based governmental plans and "top hat" arrangements for tax-exempt organizations, are not subject to 409A.[8] While certain plan types are exempt from 409A, certain plan designs may also be exempt. For example, short-term deferrals, which are benefits that will always be paid by March 15 of the year following the year during which the benefits are no longer subject to a substantial risk of forfeiture (e.g., the benefits are vested), are not subject to 409A.[9] These exempted short-term deferral arrangements may also include certain Section 457(f) arrangements for governmental and tax-exempt organizations.[10] Finally, grandfathered arrangements, where the benefits were earned and vested before 2005 (and haven't been materially modified since October 3, 2004), are not subject to 409A (but will likely be subject to pre-409A constructive receipt rules).[11]

## NOT ALL EARLY OR LATE PAYMENTS ARE 409A FAILURES

Examples of permissible early payments from non-qualified deferred compensation plans include payments up to 30 days before the scheduled payment (unless the timing was at the employee's direction),[12] payments to alternate payees under domestic relations orders,[13] limited cash-outs,[14] withholding for income taxes under Sections 457(f)[15] or 409A,[16] and the payment of FICA taxes[17] (on the 409A benefit) and related income tax withholding (on the distribution), if the plan allows. Cancellation of deferrals following an unforeseeable emergency (under 409A) or hardship distribution (under Section 401(k)) is also permissible.[18] Finally, 409A's strict plan "termination and liquidation" provisions allow the acceleration of entire categories of benefits for all participants in all similar-type plans.[19]

Examples of permissible "late" payments include payments by the later of the end of the employee's tax year or the 15th day of the third month following the date specified in the plan (provided that the employee has no choice in the tax year for receipt).[20] A plan provision can allow payments to be made during a designated period of up to 90 days after a permissible payment event (where the participant does not choose the tax year for receipt).[21] Finally, the 409A regulations also address the tax consequences associated with deferred compensation related to disputed payments and refusals to pay.[22]

## SCOPE OF DISCUSSION AND TERMINOLOGY

The scope of this discussion is the correction of 409A operational failures within the context of Notice 2008-113. It does

not address correction of document failures under Notice 2010-06 or failures that are not eligible for correction under Notice 2008-113. An employer's legal counsel may take a position of correcting 409A failures outside the Notice. Only cash-based non-qualified deferred compensation arrangements are discussed (though the principles also apply to stock-based arrangements and other payments subject to 409A).

When a correction involves a prior tax year, we assume that Form W-2 (Wage and Tax Statement)[23] had been issued to the employee and Form 1040[24] had been filed previously by the affected employee so the corrective action relies on Form W-2c[25] and Form 1040-X,[26] respectively. Otherwise, in the absence of a previously reported Form W-2 or filed return, the correction would be reported on Form W-2 and Form 1040, respectively.

To make the text less technical, we substitute "employee" for "service provider"[27] and "employer" for "service recipient."[28] "Elective deferrals" are intended to encompass all forms of elections to defer compensation whether from current pay, incentive compensation, or other one-time awards. We ignore independent contractors, whose income is reported on Form 1099-NEC, although many of the issues and corrective procedures would be similar.

## RISKS DIFFER BY PLAN TYPE

The 409A regulations separate deferred compensation arrangements into nine categories, and each category has its 409A operational risks. Non-account balance and account balance plans deserve special mention. Many non-account balance plans delay certain payouts until the later of separation from service or the plan's normal retirement age. When a participant separates from service significantly before the normal retirement age, the employer may not have a process in place for scheduling the required payout. Failing to pay participants by the end of the calendar year of the scheduled payout creates a 409A failure. Account balance plans, in contrast, may have fewer failures involving the timing of distributions than non-account balance plans do, but the stakes can be higher. Many account balance plans are denominated in notional investments (e.g., S&P 500 Index Fund). The correction process for certain failures requires the participant to forfeit the notional gain between the date of failure and the date of correction. These forfeited gains can be material and complying with Notice 2008-113's correction process can indirectly create the risk of an ERISA claim when a participant believes he has not been fully restored to where he would have been absent the failure.

## CORRECTION CATEGORIES UNDER NOTICE 2008-113

Notice 2008-113 generally categorizes operational failures into three categories: excess deferred amounts, erroneous payments, and 30 day/six-month failures. The meaning of these labels is not always obvious.

For example, excess deferred amounts are not limited to elective deferrals. Instead, excess deferred amounts encompass any instance of paying an employee too late or too little or withholding more than requested from the employee's taxable compensation. In other words, the employee received too little taxable pay. This includes elective deferrals processed for more than the amount elected or earlier than the scheduled date.

Erroneous payments encompass only certain instances of paying an employee either too much or too early. Notice 2008-113 appears to use "incorrect payment" and "failure to defer" interchangeably with "erroneous payment."

Six-month and 30-day failures are a separate category of accelerated payments and require separate correction procedures. Six-month failures are payments that do not comply with the required delay for paying specified employees[29] when separation from service triggers the payment.[30] Thirty-day failures are payments that do not comply with the 30-day limit on non-elective early payment within the *same* tax year as the scheduled payment. If amounts are paid more than 30 days early, but in a tax year different from the scheduled tax year, the payment is not a 30-day failure in the context of Notice 2008-113[31] and would require corrective action as an erroneous payment.

## THRESHOLD REQUIREMENTS

Certain requirements apply to any relief available under Notice 2008-113. For example, both the employer and the employee must attach notices (409A Relief Notices) of the 409A failure to the federal income tax return for the tax year in which the failure was discovered. Notice 2010-80 (paragraph III.H) eliminated the requirement for employees' notices for same year corrections (although a Notice continues to be required for the employer's tax return).[32] There are three similar but not identical formats for the 409A Relief Notices required under Notice 2008-113.

1. Employer's notice for corrections under Section IV—Notice 2010-80, Section III.H

2. Employer's notice for corrections under Sections V, VI, and VII—Notice 2008-113, Section IX.B.1

3. Employee's notice for corrections under Sections V, VI, and VII—Notice 2008-113, Section IX.B.2

For corrections in which the employee repays the employer, the employee is to repay the gross amount to the degree that the employer has not recovered amounts previously withheld from the federal or state governments.[33] For example, the employer generally cannot recover federal income tax or Additional Medicare Tax withheld in a previous tax year. Employees may not understand why the correction process requires them to repay an amount greater than the net amount they received. The reasoning is that income tax withholding for a previous tax year has resulted in a lower amount due when the employee filed the tax return for that year, converted an amount due to a refund, or increased a refund. Each of these scenarios has improved or will improve, the employee's cash position. If the employer cannot recover the income tax withholding, the money must come from the employee to complete the correction. Employers may be tempted to pay the employee additional amounts, but any such additional compensation will not be treated as a repayment required under Notice 2008-113.[34]

Although filing 409A Relief Notices and requiring the repayment of certain gross amounts are often the most significant threshold requirements, there are others. Employers must take commercially reasonable steps to avoid a recurrence of the failure.[35] No relief is available to employees under examination by IRS[36] or employees whose employers are experiencing a financial downturn.[37] Finally, "next year corrections" are not available to insiders, defined as officers, beneficial owners, or directors.[38] For next year corrections for non-insiders, eligible employees must have been non-insiders for the entire failure year and the entire correction year.[39] However, insider status should be carefully considered as a participant who may presently be treated as a non-insider may have been entitled to the benefit as an insider.

## OVERVIEW OF THE CORRECTION PROCESS

Subject to our introductory paragraph regarding ascertaining the relevant facts relating to the need for a possible correction, Step 1 is reviewing eligibility for relief under Notice 2008-113 and its threshold requirements. The most relevant requirement is often the determination

of whether all corrected amounts can be processed by the end of the second year following the year that the failure occurred—if not sooner. Step 2 is collecting the relevant information. Step 3 is determining which of the eleven sections in Notice 2008-113 applicable to specific failures applies, or whether additional alternatives outside of the Notice 2008-113 relief should be considered. Step 4 is working with the payroll department and benefits department (and possibly other advisors) to implement the correction process specific to the failure. Although it is beyond the scope of this article, the reader should also be mindful to be prepared to discuss any corrective action with an executive's tax or financial advisor as they are sure to inquire as to why the corrective action may be necessary.

## COLLECTING THE INFORMATION

Determine the amount and timing of what the employees should have received and what the employee did receive in each applicable tax year. Each tax year is treated separately for corrective action. For example, a six-month failure may reflect incorrect payments in two different tax years, and the correction process for each year may be different. Next, determine whether the employee was an insider. Then determine whether the overpayment or underpayment in each tax year was less than the IRC Section 402(g) limit for the year. Finally, determine whether the six-month delay or 30-day rule applies.

## DETERMINE THE APPROPRIATE SECTION

There are 12 combinations of three failure types and four correction types within Notice 2008-113. Because two of the scenarios share correction procedures, there are 11 sections instead of 12. As discussed earlier, the three failure types are excess deferred amounts, erroneous payments, and six-month/30-day failures. The four correction types are same year corrections, next year corrections for non-insiders, limited amount corrections, and other corrections.

| | **Excess Deferrals** | **Erroneous Payments** | **Six-Month/30-Days** |
|---|---|---|---|
| Same Year | Section IV.C | Section IV.A | Section IV.B |
| Next Year (Non-Insider) | Section V.D | Section V.B | Section V.C |
| Limited Amount | Section VI.C | Section VI.B | Section VI.B |
| Other | Section VII.D | Section VII.B | Section VII.C |

## THEMES IN NOTICE 2008-113

Notice 2008-113 treats each year separately and does allow for alternative corrective procedures to be "stacked" to provide appropriate relief. For example, a failure to timely pay an annuity (i.e., an excess deferral) that should have started two years ago could result in relief under some combination of V.D (next year for non-insiders), VI.C (limited amount), and VII.D (other corrections). Current year amounts can be paid by year-end without resulting in a failure. Likewise, an erroneous payment of an annuity that started two years ago could result in relief under some combination of IV.A (corrected during the current taxable year of the failure), V.B (corrected in the taxable year immediately following the failure year for non-insiders), VI.B (limited amounts that are not properly deferred or are paid prematurely), and VII.B (other corrections).

The limited amount threshold (IRC Section 402(g) limit—$19,500 for 2021) applies to the amount of failure within a given year. For example, a failure to pay an annuity of $1,000 per month results in an underpayment of $12,000 per year, which would be under the applicable 402(g) limit and thus correctable under Section VI.B of Notice 2008-113.

Interest crediting (including earnings) and notional investment gains are different and are sometimes treated differently. For example, same year correction of excess (elective) deferrals requires insiders to forfeit gains,[40] but the employer may pay interest on late amounts due to the employee to reflect the time value of money.[41] As discussed earlier, notional gains in account balance arrangements can be significant. Shielding the employee (both insiders and non-insiders) from notional losses is permissible under all sections, whereas the requirement to forfeit notional gains varies by section. For example, excess deferrals can be paid to an employee even when the amount exceeds the related account balance because of notional losses.[42] Likewise, employers are not required to adjust account balances for notional losses that would have occurred absent an accelerated payment[43] or reflect losses in corrections of excess deferrals.[44] As a practical matter, employers rarely penalize employees for losses in correcting 409A failures.

A failure in a particular year may qualify for more than one type of relief. For example, an excess deferral for a non-insider might qualify for both a next year correction and a limited amount correction.[45] The employer then weighs the pros and cons of the alternatives. A next year correction avoids the 20 percent additional tax (Form W-2 box 12 code Z)[46] but does not allow the employer to reflect notional gains or credit interest on the corrected amount.[47] A limited amount correction

does allow the employer to reflect notional gains[48] or credit interest on the corrected amount but triggers a 20 percent additional tax on the corrected amount.[49] As in all corrections under Notice 2008-113, the employer may disregard losses.[50]

A failure over more than one year may require multiple forms of relief. For example, in 2022 an employer discovers an excess deferral of $1,000 per month starting January 1, 2020, to a non-insider. Amounts that should have been already paid in 2022 may be paid by year-end without failing 409A. Amounts that should have been paid in 2021 may qualify for next year (2022) correction for non-insiders (Section V.D) or correction of a limited amount (Section VI.C if under $19,500 for 2021,). Amounts that should have been paid in 2020 may qualify for other corrections (Section VII.D).

Navigating these different sections of Notice 2008-113 can be confusing. Whereas Notice 2008-113 organizes the corrections by type of correction (i.e., same year, next year, limited amount, or other), the correction process is easier to understand when grouped by type of correction (i.e., excess deferral, erroneous payment, or six month/30-day). For this reason, it is important to map out the improper deferral or payment to assess which correction method may be most appropriate. We start with excess deferrals (e.g., amounts that should have been paid out or not deferred) because they are the most common failures. As discussed earlier, non-account balance arrangements that defer benefit commencement dates to the later of the normal retirement date or separation from service are vulnerable to this operational failure when the employer does not have a system of scheduling the benefit commencement date for deferred vested participants.

## EXCESS DEFERRALS IN GENERAL

Excess deferrals under Notice 2008-113 include all situations in which the employer owes the employee more money based on an improper deferral of taxable compensation. The four types of excess deferral corrections vary according to how much the employer pays (i.e., whether the payment includes interest crediting or notional gains that have been earned), the reporting year for Form W-2c (i.e., failure year or corrected payment year), and whether the Form W-2c includes code Z in box 12.

### Same Year Correction of Excess (Elective) Deferrals (IV.C)

This situation may be the simplest failure to address. Same year corrections of excess deferrals are limited to elective deferrals, where the employer's payroll organization has reduced the participant's

current compensation by an amount more than the participant's elected amount. The participant received too little current pay and the employer owes the participant money. To correct the failure, the employer pays the employee by the end of the year in which the excess deferral took place. Employers may pay interest on the late amount, but insiders forfeit investment gains attributable to the delayed payment date.[51] Form W-2 reflects the amount paid without code Z in box 12. For non-elective arrangements (i.e., situations where the employee/participant does not elect to defer a particular amount of taxable compensation), late payment by the employer within the same calendar year qualifies as timely payment.[52]

**Next Year Correction of Excess Deferrals for Non-Insiders (V.D)**

Only non-insiders are eligible for this correction process.[53] To correct the failure, the employer pays the employee by the end of the year following the year in which the failure occurred. Employers may not pay interest on the late amount to anyone to whom the failure relates,[54] and the affected participants will forfeit investment gains attributable to the delayed payment date.[55] Form W-2 for the year of the correction payment reflects the amount paid without code Z in box 12.[56]

**Correction of Limited Amount Excess Deferrals (VI.C)**

Only aggregated underpayments of less than the IRC Section 402(g) limit for the failure year are eligible for this relief. The aggregation applies to underpayments to an individual participant from all 409A plans of the same 409A aggregation category (e.g., all non-account balance plans that are sponsored by the employer).[57] For example, an employer failed to pay a non-account balance SERP benefit of $1,000 per month beginning on January 1, 2020, and discovers the failure in 2021. Because the $12,000 in excess deferrals is less than the Section 402(g) limit of $19,500 for 2020, the failure qualifies as a limited amount. If the employer had failed to pay a second non-account balance SERP benefit of $1,000 per month beginning on January 1, 2020, the combined total of $24,000 would exceed the Section 402(g) limit and would not qualify as a limited amount.[58]

To correct a limited amount excess deferral, the correcting payment must be made by the end of the second year after the year of the failure (i.e., the year during which the payment should have been made).[59] The employer may include interest or notional gain[60] on the late payment (or the employee's earnings allocable to the late payment may be forfeited), but the correcting payment is reported on Form W-2 for the correcting payment year with code Z in box 12.[61]

### Excess Deferrals—Other Failures (VII.D)

Excess deferrals relating to other failures can also be corrected if, under the terms of the plan and any applicable deferral election, an amount of deferred compensation under the plan should have been paid or made available to the employee during the employee's taxable year, or an amount is treated as deferred compensation under the plan that should have been paid or made available to the employee during the employee's taxable year, but such amount erroneously is not paid or made available to the employee. To correct these types of excess deferrals, the correcting payment must be made by the end of the second taxable year after the taxable year in which the failure occurred.[62] The employer may *not* include interest or notional gain on the late payment,[63] and the correcting payment is reported on Form W-2c for the *failure* year with code Z in box 12.[64] It is also important to note that following the corrective payment, the participant's remaining account balance must be adjusted for earnings (e.g., earnings credited on the excess deferrals should be forfeited) and the account balance may be adjusted for losses retroactive to the date the excess amount was incorrectly credited to the employee's account or otherwise incorrectly treated as deferred under the plan. This adjustment must be made on or before the last day of the employee's taxable year in which such an amount was paid to the employee.[65]

## ERRONEOUS PAYMENTS IN GENERAL

Erroneous payments under Notice 2008-113 include most situations in which the employee received taxable compensation and owes the employer money. Exceptions to the repayment obligation include corrections of six-month and 30-day failures, which have separate requirements. The four types of erroneous payment corrections vary according to whether the employee repays the amount, whether the employee pays interest, whether any notional gains that would have been earned are credited to the account balance, the tax effect of the repayment, the reporting year for Form W-2c (i.e., failure year or repayment year), and whether the Form W-2c includes code Z in box 12. Non-insiders may be eligible for more lenient repayment schedules if the correction is in the same year[66] or year following the failure.[67]

Employers often seek ways to facilitate the repayment of erroneous payments. Employers may reduce other compensation that would have been paid to the employee, but that other compensation is included in income.[68] If the employer pays the employee an amount intended as a substitute for the repayment, the originally deferred

amount will not be treated as having been repaid and the violation may be treated as continuing.[69]

Repayments are for the gross amount unless the employer has made a tax correction on Form 941-X to recover the amount of taxes withheld on the amount erroneously paid.[70] Generally, employers may correct federal income tax withholding errors only if the errors are discovered in the same calendar year that the wages are paid. Employers may correct Social Security Tax and Medicare Tax for the past three years, but any Additional Medicare Tax paid in past years must be addressed by correcting the individual tax return.

**Same Year Correction of Erroneous Payment (IV.A)**

Same year corrections of erroneous payments require repayment by the employee in the year during which the erroneous payment was made, and insiders pay interest on amounts that exceed the 402(g) limit (short term AFR for the month of mistaken payment prorated for days outstanding).[71] It is noteworthy that if repayments by non-insiders would result in financial hardship to the employee, the employee and employer may enter into an agreement permitting repayment (with interest) over an up to 24-month period from the due date of the employee's federal income tax return for the year (including extensions).[72] For account balances with notional investments, missed gains can be restored to the account balance.[73] Form W-2 for the taxable year of the erroneous payment does not need to reflect the mistaken payment,[74] and repayment by the employee is neither deductible nor included in basis.

**Next Year Correction of Erroneous Payment to Non-Insider (V.B)**

Correction of an erroneous payment in the year following the year of the erroneous payment to a non-insider requires the employee to repay the amount with interest.[75] The account balance may reflect gains that were missed because of the erroneous payment.[76] Assuming the payment is reflected in the Form W-2 for the failure year, no W-2c for the failure year is required. The employee takes an "above the line" deduction for the repayment (exclusive of the interest),[77] but it is not clear how this deduction would be reported on Form 1040, Schedule 1, Part II. The scheduled payment is included in the employee's taxable income in the year when paid.

A special rule applies when the scheduled payment is properly payable in the year following the year of the erroneous payment (i.e., the same year as the year of correction). In this situation, no repayment is required, but the employee is required to pay interest

on the erroneous payment from the date of the erroneous payment to the repayment date.[78] The erroneous payment remains reportable on Form W-2 in the year paid.[79] No payment is made at the time the correct payment should have been made. This corrective procedure is not available if the payment relates to erroneous payment to a specified employee in violation of the 6-month delay following separation from service.[80]

**Correction of Erroneous Payment of Limited Amount (VI.B)**

Correction of an erroneous payment of a limited amount does not require the employee to repay the amount or pay interest. Instead, Form W-2c for the failure year reflects code Z in box 12, which triggers the 20 percent additional tax on the erroneous payment.[81]

In this context, erroneous payments under this corrective procedure include both six-month failures and 30-day failures.[82] Furthermore, it appears that erroneous payments that qualify for next year correction of amounts paid to insiders count toward the threshold for the aggregated amounts.[83] The threshold applies to only the applicable tax year and the applicable aggregation category (e.g., elective account balance arrangements).

**Erroneous Payments—Other Failures (VII.B)**

Corrections of other erroneous payments (excluding payments before completion of the six-month delay for specified employees) require repayment by the employee,[84] and insiders pay interest on the payments.[85] For account balances with notional investments, missed gains can be restored to the account balance.[86] The employee is required to pay the additional 20 percent tax for the year in which the amount is included in income but is not required to pay the premium interest tax.[87] A corrective Form W-2c for the failure year reflects code Z in box 12. The repayment amount is non-deductible, but the amount is included in basis.[88] Presumably, this tax basis is recovered first-in-first-out, consistent with the example in proposed Treasury Regulation Section 1.457-12(d)(5)(iii).

## SIX-MONTH AND 30-DAY FAILURES IN GENERAL

Six-month and 30-day failures generally require a different correction process than other failures where the employee has been paid an amount that should have been (or continued to have been) deferred. Notice 2008-113 reserves some of the harshest treatment for these failures by forcing the forfeiture of any notional gains that would have been earned absent the premature payment. This

is particularly important in account balance plans denominated in notional investments during rising stock markets.

Certain plans include a universal six-month delay for payments triggered by separation from service for all participants in the plan, usually to avoid the administrative effort of identifying specified employees each year. A careful reading of the scope of the correction procedures for six-month failures suggests that a six-month failure in such a plan may not need to be corrected under the correction procedures for six-month failures unless the benefit "would have been payable less than six months after the service provider's separation from service if the service provider had not been a specified employee."[89] Thus, for example, if no benefits under the plan could be paid before 6 months after separation from service, there may be a basis to conclude that a 6-month failure for specified employees has not occurred. However, informal conversations with both current and former IRS staff indicate that this may not have been their intention. Absent additional guidance, a six-month failure should follow the correction procedures for six-month failures even when the plan features a universal six-month delay for payments triggered by separation from service.

The four types of six-month/30-day corrections vary according to whether the employee is required to repay the incorrect amount, Form W-2c reporting, and the tax treatment of any repayment. Unless the correction is for a limited amount, correction requires repayment (without interest), a delay in the timing of the originally scheduled benefit (to reflect the number of days of early possession of the benefit), and forfeiture of any notional gains. Correction of limited amounts follows the process for corrections of erroneous payments of limited amounts, where no repayment is required.

**Same Year Correction of Six-Month and 30-Day Failures (IV.B)**

Same year corrections of six-month and 30-day failures require repayment by the employee, but without interest.[90] For account balances with notional investments, employees forfeit any missed gains.[91] Form W-2 does not reflect the mistaken payment, and repayment by the employee is neither deductible nor included in basis.[92]

For early payments that are repaid before the originally required payment date, the new payment date should reflect a delay equal to the number of days that the specified employee held the money before the originally scheduled payment date.[93] For example, a specified employee separates from service on December 15, 2008, so that the payment is due on July 1, 2009. The employer erroneously pays the specified employee the amount of deferred compensation on March 1, 2009 (122 days before the original payment due date). Employer discovers

the error on May 1, 2009, and the specified employee repays the amount to the employer on June 1, 2009 (92 days after the erroneous payment and before the originally scheduled payment date). Provided that immediately after such repayment the specified employee has a legally binding right to receive the repaid amount from the employer on October 1, 2009 (92 days after July 1, 2009, original payment due date) and the employer does not repay the amount to the specified employee before that date, the specified employee will not be treated as having failed to comply with 409A and the terms of the plan and the applicable deferral election solely as a result of the early payment.[94]

**Next Year Correction of Six-Month and 30-Day Failures for Non-Insiders (V.C)**

Next year corrections of six-month and 30-day failures are very similar to same year corrections and require repayment by the employee without interest.[95] For account balances with notional investments, employees forfeit any missed gains.[96] The mistaken payment remains reported on Form W-2 for the failure year and no code Z is required.[97] A new payment date reflects a delay equal to the number of days that the employee held the money before the originally scheduled payment date.[98] If the repayment and the ultimate payment occur in the same year, then repayment is non-deductible, and the ultimate payment is not taxable.[99] If the repayment and the ultimate payment occur in different years, then the employee receives an above-the-line deduction for the repayment and the ultimate payment is reported on Form W-2.[100]

**Correction of Limited Amount Six-Month and 30-Day Failures (VI.B)**

Corrections of limited amount six-month and 30-day failures[101] follow the same process as correction of erroneous payments of a limited amount and do not require the employee to repay the amount or pay interest. Instead, Form W-2c for the failure year reflects code Z in box 12, which triggers the 20 percent additional tax on the erroneous payment.[102]

**Other 30-Day Failures and Six-Month Failures (VII.C)**

Corrections of other six-month and 30-day failures require repayment by the employee without interest.[103] For account balances with notional investments, employees forfeit any missed gains.[104] The mistaken payment requires a code Z on the W-2c for the failure year.[105] A new payment date reflects a delay equal to the number of days that the employee held the money before the originally scheduled payment date.[106] The employee receives no deduction for the repayment but

is treated as having previously included the repayment amount in income.[107]

**Additional Comments**

While Notice 2008-113 can prove helpful for several erroneous payment situations, it is not unusual for employers to discover errors encompassing periods before the preceding two years to which the relief in Notice 2008-113 will not apply. While addressing those issues is beyond the scope of this article, the authors and other practitioners are mindful of the significant tax penalties that can result from falling outside of Notice 2008-113. In those situations, employers will want to evaluate other tax positions (e.g., open tax years, constructive receipt rules, etc.) before reconciling to paying the fairly draconian penalties that may otherwise apply.

## SUMMARY

Timing is important when correcting 409A operational failures. Correcting within the same year is the least burdensome, and all corrections must be made by the end of the second year following the failure for an employer and employee to avail themselves of the generous relief under IRS Notice 2008-113. Although the requirements for relief under Notice 2008-113 may seem onerous, especially for unintentional administrative errors, the potential relief from the full effect of 409A penalties can be significant.

## NOTES

1. Treas. Reg. § 1.409A-6.
2. For purposes of Notice 2008-113, an employee is an insider with respect to an employer if the employee is a director or officer of the employer or is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security of the employer, determined in accordance with the rules of the Securities and Exchange Commission under § 16 of the Securities Exchange Act of 1934, as amended, 15 USC 78p, without regard to whether the employer has any class of equity securities registered under § 12 of such Act, 15 USC 78l. *See* 17 CFR § 240.16a-1(a) (beneficial owner) and (f) (officer). In the case of an employer that is not a corporation, such rules are applied by analogy. IRS Notice 2008-113, Section III.G.
3. Treas. Reg. § 1.409A-1(i).
4. IRS Notice 2010-80, Section III.H.
5. Preamble to Proposed Treas. Reg. § 1.409A-4, Section III.B.1, footnote 2.
6. Treas. Reg. § 1.409A-1(a)(2).
7. Treas. Reg. § 1.409A-1(a)(5).
8. Treas. Reg. § 1.409A-1(a)(2)(vii).

9. Treas. Reg. § 1.409A-1(b)(4).
10. Treas. Reg. § 1.409A-1(a)(4).
11. Treas. Reg § 1.409A-6(a)(4).
12. Treas. Reg § 1.409A-3(d).
13. Treas. Reg § 1.409A-3(j)(4)(ii).
14. Treas. Reg § 1.409A-3(j)(4)(v).
15. Treas. Reg § 1.409A-3(j)(4)(iv).
16. Treas. Reg § 1.409A-3(j)(4)(vii).
17. Treas. Reg § 1.409A-3(j)(4)(vi).
18. Treas. Reg, § 1.409A-3(j)(4)(viii).
19. Although it is beyond the scope of this article, plan designs and related plan provisions that contemplate distributions following a change in control or plan termination may prove quite helpful in avoiding improper payment situations. *See, e.g*., Treas. Reg § 1.409A-3(j)(4)(ix)(B), Treas. Reg. § 1.409A- 3(j)(4)(ix)(C).
20. Treas. Reg. § 1.409A-3(d).
21. Treas. Reg § 1.409A-3(b).
22. Treas. Reg. § 1.409A-3(j)(4)(xiv).
23. Form W-2 is annual form for each employee (or former employee) that reports taxable income, FICA wages, and withholding.
24. Form 1040 is the individual income tax return.
25. Form W-2c is a correction of Form W-2.
26. Form 1040-X is a correction of Form 1040.
27. Treas. Reg. § 1.409A-1(f).
28. Treas. Reg. § 1.409A-1(g).
29. Treas. Reg. § 1.409A-1(i).
30. Treas. Reg. § 1.409A-3(i)(2).
31. IRS Notice 2008-113, Sections V.C.2(a) and VII.C.2(a).
32. IRS Notice 2010-80, Section III.H.
33. IRS Notice 2010-06, Section XIII.A.
34. *Ibid*.
35. IRS Notice 2008-113, Section III.B.
36. IRS Notice 2008-113, Section III.C.
37. IRS Notice 2008-113, Section III.F.
38. IRS Notice 2008-113, Section III.G.
39. IRS Notice 2008-113, Section V.A.
40. Insiders are subject to an adjustment for earnings retroactive to the date the excess amount was incorrectly credited to the employee's account or otherwise incorrectly treated as deferred under the plan, provided that such adjustment must be made on or before the last day of the employee's taxable year in which such amount was incorrectly treated as deferred compensation under the plan. The employer may but is not required to adjust for earnings for non-insiders. IRS Notice 2008-113, Section IV.C.3.
41. IRS Notice 2008-113, Section IV.C.4 (last sentence in the example).
42. IRS Notice 2008-113, Section IV.C.3.

43. For erroneous payments, see Section IV.A.4 (and example 1 in Section IV.A.5), Section V.B.4, and SectionVII.B.4. For six-month and 30-day failures, *see* Section IV.B.4, Section V.C.4, and Section VII.C.4. Corrections of limited amounts (Section VI) do not require repayment, so adjusting for notional losses is not relevant.
44. For excess deferrals, see Section IV.C.3, Section V.D.3, Section VI.C.4, and Section VII.D.4.
45. IRS Notice 2008-113, Section V.A and Section VI.A.
46. IRS Notice 2008-113, Section V.D.
47. IRS Notice 2008-113, Section V.D.3 and Section V.D.4.
48. IRS Notice 2008-113, Section VI.D.
49. IRS Notice 2008-113, Section VI.C.3.
50. *Ibid*.
51. IRS Notice 2008-113, Section IV.C.3.
52. Treas. Reg. § 1.409A-3(d).
53. IRS Notice 2008-113, Section V.A.
54. IRS Notice 2008-113, Section V.D.2(d).
55. IRS Notice 2008-113, Section V.D.3.
56. IRS Notice 2008-113, Section V.D.4.
57. IRS Notice 2008-113, Section VI.C.2(c).
58. While some employers may have wanted to attempt to rely upon the exclusion of payments up to the 402(g) limit (e.g., $19,500 of the $24,000 in payments), Notice 2008-113 anticipated that approach and notes that to rely upon the 402(g) limit as a correction, the amount paid or made available to the employee cannot exceed the limit on elective deferrals that would apply to a qualified plan under Section 402(g)(1)(B) for the year of the operational failure. Thus, this 402(g) relief will apply only if any erroneous payments under the plan, in the aggregate, of amounts that otherwise should have been treated as deferred compensation concerning the employee during the taxable year (or should have continued to be deferred compensation during the taxable year), do not exceed the limit on elective deferrals that would apply to a qualified plan under § 402(g)(1)(B) for such year. IRS Notice 2008-113, Section VI.B.
59. IRS Notice 2008-113, Section VI.C.2(d).
60. IRS Notice 2008-113, Section VI.C.4.
61. IRS Notice 2008-113, Section VI.C.3.
62. IRS Notice 2008-113, Section VII.A.
63. IRS Notice 2008-113, Section VII.D.4.
64. IRS Notice 2008-113, Section VII.D.3.
65. IRS Notice 2008-113, Section VII.D.4.
66. IRS Notice 2008-113, Section IV.A.2(b).
67. IRS Notice 2008-113, Section V.
68. IRS Notice 2008-113, Section III.E.
69. Whether a payment or a right to a payment acts as a substitute for a payment of deferred compensation is determined based on all the facts and circumstances. However, where the payment of an amount results in an actual or potential reduction of, or current or future offset to, an amount of deferred compensation, or if the employee receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount

deferred under a non-qualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation. The payment of an amount or creation of a new right to a payment proximate to the purported forfeiture or voluntary relinquishment of a right to deferred compensation is presumed to be a substitute for the deferred compensation. Treas. Reg. 1.409A-3(f).

70. IRS Notice 2010-06, Section XIII.A.
71. IRS Notice 2008-113, Section IV.A.1(d).
72. IRS Notice 2008-113, Section IV.A.2(b).
73. IRS Notice 2008-113, Section IV.A.4.
74. IRS Notice 2008-113, Section IV.A.3.
75. IRS Notice 2008-113, Section V.B.2(b).
76. IRS Notice 2008-113, Section V.B.4.
77. IRS Notice 2008-113, Section V.B.3.
78. IRS Notice 2008-113, Section V.B.2(b).
79. IRS Notice 2008-113, Section V.B.3.
80. IRS Notice 2008-113, Section V.B.2(a).
81. IRS Notice 2008-113, Section VI.B.3.
82. IRS Notice 2008-113, Section VI.B.2(a).
83. IRS Notice 2008-113, Section VI.B.2(c).
84. IRS Notice 2008-113, Section VII.B.2(c).
85. IRS Notice 2008-113, Section VII.B.2(d).
86. IRS Notice 2008-113, Section VII.B.4.
87. IRS Notice 2008-113, Section VII.B.3.
88. IRS Notice 2008-113, Section VII.B.5 (last sentence of example).
89. IRS Notice 2008-113, Section VI.B.2(a), Section V.C.2(a), and Section VII.C.2(a).
90. IRS Notice 2008-113, Section IV.B.2(b).
91. IRS Notice 2008-113, Section IV.B.4.
92. IRS Notice 2008-113, Section IV.B.3.
93. IRS Notice 2008-113, Section IV.B.2(b).
94. IRS Notice 2008-113, Section IV.B.5 (Ex. 1 and 2).
95. IRS Notice 2008-113, Section V.C.2(b).
96. IRS Notice 2008-113, Section V.C.4.
97. IRS Notice 2008-113, Section V.C.3.
98. IRS Notice 2008-113, Section V.C.2(c).
99. IRS Notice 2008-113, Section V.C.3.
100. *Ibid.*
101. IRS Notice 2008-113, Section VI.B.2(a).
102. IRS Notice 2008-113, Section VI.B.3.
103. IRS Notice 2008-113, Section VII.C.2(c).
104. IRS Notice 2008-113, Section VII.C.4.
105. IRS Notice 2008-113, Section VII.C.3.
106. IRS Notice 2008-113, Section VII.C.2(d).
107. IRS Notice 2008-113, Section VII.C.3.

# A Profits Interest: Basics

**BY BRUCE J. MCNEIL**

Bruce J. McNeil, Esq. is considered one of the country's foremost experts in the area of executive and deferred compensation. Mr. McNeil testified as an expert before the United States Senate Committee on Finance on executive compensation matters during the ENRON Corporation hearings. He also testified before the ERISA Advisory Council of the Department of Labor as an expert regarding executive and deferred compensation matters.

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Mr. McNeil is the author of over 40 books and is the Editor-in-Chief of both the Journal of Pension Planning & Compliance and the Journal of Deferred Compensation: Nonqualified Plans and Executive Compensation, quarterly publications published by Wolters Kluwer and distributed nationally. Mr. McNeil is also the author or co-author of over 100 articles on employee benefits matters. Mr. McNeil is a Fellow of the American College of Employee Benefits Counsel.

A member of the Bar in multiple jurisdictions, including Washington, D.C. and Minnesota, Mr. McNeil is also admitted to practice in the United States Supreme Court, the United States Tax Court as well as several Courts of Appeal and District Courts. He has been an adjunct professor of law at the University of Minnesota Law School and formerly served with the Employee Plans Technical and Actuarial Division of the Internal Revenue Service in Washington, D.C. He has been listed in Best Lawyers since 2006. Mr. McNeil serves as Chair of the PSCA's Non-Qualified Deferred Compensation Committee, and he is also a member of the Board of Directors of the PSCA.

In a partnership arrangement, a partner may enter into a compensation agreement pursuant to which the partner would receive a percentage of the proceeds from each investment made with the assets of the partnership for services rendered with respect to the investments, referred to as a "profits interest." This compensation arrangement frequently occurs with respect to a private equity investment group. In that case, a private equity investment group organized as a limited liability company or partnership will generally grant to the general partner the right to an agreed upon percentage (*e.g.*, 20 percent) of the aggregate net gains of the investment fund.

The capital of the other investors will "carry" the general partner during the investment period; so, the agreement with the general partner referred to as the "profits interest" is also known as a "carried interest."

A private equity investment group will structure the form of the private equity funds based upon one of the four broad categories: (i) direct investment funds; (ii) funds of funds; (iii) parallel funds; and (iv) hybrid funds.

Typically, the sponsor of a direct investment fund will organize the fund as a limited partnership, a limited liability company or other form of pass-through entity for U.S. tax purposes. The fund will have a fixed investment period, for example, seven to 10 years, reflecting the expected holding period of the portfolio investments. Generally, fund investors will allocate capital earmarked for specific private equity funds, in particular, investments within narrow sectors of the market. A direct investment fund also may be structured to invest directly into a specific investment or fund, or may invest a portion of its capital in a funds of funds, or in a parallel vehicle for special investments or for specific types of investors such as tax-exempt investors. Funds of funds is an entity form established for the sole purpose of investing in other private equity funds in order to spread the risk and consequently, the reward. A parallel fund is generally structured in a manner to serve the special tax objectives of a tax-exempt investor or a foreign investor to retain the desired tax consequences. Except as necessary to accommodate those objectives, parallel funds do not differ from other fund prototypes in basic objective investments or expected investment period. A hybrid fund is a fund that merges two or more of the basic categories within a single entity.

The purpose of a private equity fund will include a wide range of investment categories, such as (i) a venture capital fund or (ii) a leveraged buyout fund. A venture capital fund is probably the most conventional form for a private equity fund. A venture capital fund will invest capital in a privately owned business during the early stages of product or service development. The business initially will generate losses in the expectation of revenue growth and market share and will, consequently, lack the necessary cash flow to rely on more conventional financing sources, such as banks or other institutional lenders. A leverage buyout fund will invest primarily in established businesses with substantial borrowing capacity. In a typical investment, the fund will acquire a controlling interest in the business in order to develop the business and sell the business at a later date of the fund's choosing. The fund will usually organize a corporate acquisition vehicle, which then will acquire the stock or assets of the portfolio company.

The investors in a private equity fund generally will not invest the entire capital commitment at once; instead, there is a commitment to invest a fixed amount of capital in stages, commonly referred to as the "investment period."

When the private equity fund sells investments, which may include the controlling interest in a business, the profits (or losses) are determined. The economic agreement that governs the distribution of the proceeds by the fund, whether in the form of cash or marketable securities, is referred to as the "distribution waterfall." Investors in a private equity fund will achieve liquidity as and when the fund sells its investments. Return of capital distributions will usually follow one of the three methodologies: (i) investment-by-investment; (ii) realized aggregation; or (iii) full aggregation.

A private equity fund that distributes proceeds based upon the investment-by-investment methodology will reimburse capital and expenses allocable only to the sold investment. The following example illustrates an investment-by-investment methodology.

> Assume a fund that provides for a 20% profits interest makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $16 million. At the end of year three, it sells B for $30 million. Assume no management fee or other fees and expenses. At the end of year two, the fund will distribute the entire $16 million to the investors. At the end of year three, the fund will distribute $20 million to the investors, $2 million to the general partner and $8 million to the investors. The fund therefore distributes 20% of the aggregate $10 million gain on B to the general partner even though it has realized a net gain of only $6 million.

Because this distribution methodology will allow the general partner to participate in investment proceeds even if the fund has not yet realized a net gain, few private equity funds use this methodology.

In a fund that aggregates gains and losses on realized investments, the fund will first distribute investment proceeds to reimburse capital and expenses allocable to the investment and then reimburse unrecovered losses on prior sales. The following example illustrates this methodology.

> Assume a fund that provides for a 20% profits interest again makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $16

> million. At the end of year three, it sells B for $30 million. Assume no management fees or other fees and expenses. At the end of year two, the fund will distribute the entire $16 million to the investors. At the end of year three, the fund will distribute $24 million to the investors, $1.2 million to the general partner and $4.8 million to the investors. Although the fund has realized a gain of $10 million on B, the gain exceeds previous losses by only $6 million. To reimburse the investors for the $4 million of loss on A, therefore, the fund will distribute the first $4 million of gain on B to the investors.

In a fund that provides for full aggregation, the general partner will receive carry distributions only after the fund reimburses all invested capital, not merely capital allocable to previously sold investments. The following example illustrates this methodology.

> Assume a fund that provides for a 20% profits interest again makes three portfolio investments at a cost of $20 million each in A, B and C. At the end of year two, it sells A for $24 million. At the end of year three, it sells B for $30 million. Assume no management fees or other fees and expenses. At the end of years two and three, the fund will distribute the entire $24 million and $30 million to the investors even though it has realized a $14 million gain because total invested capital (i.e., $60 million) still exceeds total investment proceeds (i.e., $54 million). The fund will then distribute 20% of any investment proceeds on C in excess of $6 million to the general partner in respect of the profits interest.

Regardless of the distribution methodology (*i.e.*, investment-by-investment, realized aggregation, full aggregation), the general partner will not earn its profits interest until the fund returns aggregate invested capital to its investors. The reason is that the general partner "earns" the profits interest only if aggregate investment gains exceed aggregate losses.

Despite the relative uncertainty of the realization of investment gains or losses, a private equity fund that distributes either on an "investment-by-investment" or "realized aggregation" basis will allow current distributions to the general partner. The assumption implicit in such a private equity fund is that the retained investments will ultimately realize gains at least sufficient to reimburse any

remaining unreturned capital. This may produce excess distributions to the general partner during periods that precede the liquidation of the fund. The effect of such distributions is to reward the general partner for accelerating the sale of investments that realize a gain and deferring the sale of investments that have not yet realized a gain by providing its investors with the interim use of the funds. Consequently, in order to reconcile the aggregation of gains and losses with respect to the investments, a private equity fund will impose a "clawback" obligation. To reconcile the aggregate nature of the profits interest with the market practice of distributing proceeds on an "investment-by-investment" or "realized aggregation" basis, the private equity fund will "clawback" earlier distributions made to the general partner.

Assuming that the fund has properly allocated profit and loss, a general partner that contributes no capital to the fund generally will have a negative capital account at liquidation equal to its unearned distributions. Therefore, in a private equity fund that provides for a clawback, the general partner and its investors are required to restore earlier distributions, which the fund will then redistribute to the investors who have contributed capital to the fund. The following example illustrates the effect of a clawback.

> Assume a fund that provides for a 20% profits interest to the general partner makes three portfolio investments at a cost of $20 million each in A, B and C. Assume that the fund distributes investment proceeds on a "realized aggregation" basis. At the end of year one, it sells A for $30 million, distributing $20 million to the investors to reimburse capital allocable to A and the remaining $10 million, 80% to the investors (i.e., $8 million) and 20% to the general partner (i.e., $2 million) in respect of its profits interest. At the end of year two, it sells B for $24 million and distributes $20 million to the investors to reimburse capital allocable to B and the remaining $4 million, 80% to the investors (i.e., $3.2 million) and 20% to the general partner (i.e., $.8 million) in respect of its profits interest. At the end of year three, the fund sells C for $8 million and liquidates. When it distributes the full proceeds to the investors, the investors will have received aggregate distributions of only $59.2 million (i.e., $20 million + $8 million + $20 million + 3.2 million + $8 million), which is less than the $60 million of invested capital. The fund therefore require the exercise of the clawback provision. Because the fund realized a net

gain of only $2 million ($62 million—$60 million) over the life of the venture, the general partner should have received only $0.4 million, not $2.8 million. The general partner therefore returns $2.4 million to the fund for redistribution to the investors.

## A BRIEF HISTORY OF A PROFITS INTEREST

The benefit of a profits interest is not only the percentage of the investment gain realized by the general partner but the tax treatment of the partnership interest. The tax treatment afforded a profits interest has been addressed only by a few courts and the decisions have focused on whether the partnership interest is speculative or is, instead, a transfer at fair market value. Those decisions, *Diamond v. C. I. R.*, 492 F.2d 286 (7th Cir. 1974) and *Campbell v. C.I.R.*, 943 F.2d 815 (8th Cir. 1991), are discussed in great detail later, but briefly discussed here.

In the first case, *Diamond v. C. I. R.*, 492 F.2d 286 (7th Cir. 1974), the Seventh Circuit determined that the market value of the partnership interest conferred on the partner, in return for services, was determinable and ordinary income as compensation for services. The Seventh Circuit rejected Diamond's argument that the receipt of a profit share was not a taxable event as compensation but proceeds of a sale and taxable as a capital gain because it was a receipt of a capital interest and a service partner who received a profits interest did not recognize ordinary income. Diamond, 492 F.2d at 288–89. The court noted that Section 721 of the Internal Revenue Code, the section on which Diamond relied, applied only to those partners who contributed property to the partnership and that the application of Section 1.721-1(b)(1) of the Treasury Regulations was also so limited. Diamond, 492 F.2d at 288. After considering other published views on the matter, the court declined to interpret the regulation as Diamond proposed. Diamond, 492 F.2d at 289–91. Although it affirmed the tax court, the Seventh Circuit noted the presence of strong views to the contrary, Diamond, 492 F.2d at 289, and recognized the limitations of its holding:

> There must be wide variation in the degree to which a profit-share created in favor of a partner who has or will render service has determinable market value at the moment of creation. Surely in many if not the typical situations it will have only speculative value, if any.

Diamond, 492 F.2d at 290.

In *Campbell v. C.I.R.*, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit, on the other hand, determined that a partnership interest that was speculative should not be a taxable event on transfer and taxable as ordinary income (consistent with the dictum of the Seventh Circuit). The Eighth Circuit stated that, more troubling however, was Campbell's argument that the profits interests he received had only speculative, if any, value. The court in this case fully agreed with this contention and reversed the tax court. As earlier noted by the tax court, "fair market value is 'the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed' of all the relevant circumstances." *See Palmer v. C. I. R.*, 523 F.2d 1308, 1310 (8th Cir. 1975) (quoting *Hamm v. C.I.R.*, 325 F.2d 934, 937 (8th Cir. 1963)). The court stated that while it reviewed de novo the basis of a fair market value determination, the ultimate question of value was one of fact. *See Estate of Palmer v. C.I.R.*, 839 F.2d 420, 423 (8th Cir. 1988).

### ***DIAMOND V. C. I. R.*, 492 F.2D 286 (7TH CIR. 1974)**

In *Diamond v. Commissioner of Internal Revenue*, 56 T.C. 530, 1971 WL 2461 (1971), Diamond, the appellant, sought review of a tax court judgment affirming a deficiency assessment determination that in exchange for services the appellant realized ordinary income on receipt of a profit share derived from a real estate venture and that commissions paid to bank officers on mortgage broker commissions were not deductible as business expenses.

The appellee, the Commissioner of Internal Revenue, assessed unrelated deficiencies against the appellant, having determined that the appellant realized ordinary income on the receipt of a right to a share of profit or loss to be derived from a real estate venture, in exchange for his services, and that commissions he paid to bank officers on his commissions as a mortgage broker were not deductible business expenses. The tax court affirmed the appellee's assessments. On appeal, the court affirmed, holding that the receipt of a profit share with a determinable market value was ordinary income. The court stated that only if by strained construction "property" were said to include services would Section 721 say anything about effect of furnishing services. With respect to commissions, the tax court's findings were not clearly erroneous that appellant failed to prove that he received this money as a conduit and not under claim of right, nor that appellant failed to

prove that this type of payment to the lender's officers was ordinary and necessary.

This case was an appeal from a decision of the Tax Court upholding the commissioner's assessment of deficiencies against Sol and Muriel Diamond for the years 1961 and 1962. The deficiencies for each year were consolidated for trial, but were essentially unrelated. The Tax Court concluded that Diamond realized ordinary income on the receipt of a right to a share of profit or loss to be derived from a real estate venture (the 1962 partnership case), and that certain commission payments he made were not deductible business expenses (the 1961 commissions case).

During 1961, Diamond was a mortgage broker. Philip Kargman had acquired for $25,000 the buyer's rights in a contract for the sale of an office building. Kargman asked Diamond to obtain a mortgage loan for the full $1,100,000 purchase price of the building. Diamond and Kargman agreed that Diamond would receive a 60 percent share of profit or loss of the venture if he arranged the financing.

Diamond succeeded in obtaining a $1,100,000 mortgage loan from Marshall Savings and Loan. On December 15, 1961, Diamond and Kargman entered into an agreement which provided: (i) the two were associated as joint venturers for 24 years (the life of the mortgage) unless earlier terminated by agreement or by sale; (ii) Kargman was to advance all of the cash needed for the purchase beyond the loan proceeds; (iii) profits and losses were to be divided, 40 percent to Kargman, 60 percent to Diamond; and (iv) in the event of sale, proceeds were to be devoted first to repayment to Kargman of money supplied by him, and net profits thereafter were to be divided, 40 percent to Kargman and 60 percent to Diamond.

Early in 1962, Kargman and Diamond created an Illinois land trust to hold title to the property. The chief motivation for the land trust arrangement was apparently to insulate Diamond and Kargman from personal liability on the mortgage note.

The purchase proceeded as planned and closing occurred on February 18, 1962. Kargman made cash outlays totaling $78,195.33 in connection with the purchase. Thus, under the terms of the agreement, the property had to appreciate at least $78,195.33 before Diamond had any equity in it.

Shortly after closing, it was proposed that Diamond would sell his interest and Liederman would be substituted, except on a 50–50 basis. Liederman persuaded Diamond to sell his interest for $40,000. This sale was effectuated on March 8, 1962, by Diamond assigning his interest to Kargman for $40,000. Kargman in turn conveyed a similar interest, except for 50–50 sharing, to Liederman for the same amount.

On their 1962 joint return, the Diamonds reported the March 8, 1962, $40,000 sale proceeds as a short-term capital gain. This gain was offset by an unrelated short-term capital loss. They reported no tax consequences from the February 18 receipt of the interest in the venture. Diamond's position was that his receipt of this type of interest in partnership was not taxable income although received in return for services. He relied on Section 721 and Section 1.721-1(b)(1) of the Treasury Regulations. He further argued that the subsequent sale of this interest produced a capital gain under Section 741. The Tax Court held that the receipt of this type of interest in partnership in return for services was not within Section 721 and was taxable under Section 61 when received. The Tax Court valued the interest at $40,000 as of February 18, as evidenced by the sale for that amount three weeks later, on March 8.

Both the taxpayer and the Tax Court treated the venture as a partnership and purported to apply partnership income tax principles. It was suggested that the record could have supported findings that there was in truth an employment or other relationship, other than partnership, and produced a similar result, but those findings were not made. See Cowan (1972) The Diamond Case. *Tax Law Review*, 27, 161. It was also suggested (and argued, alternatively, by the government) that although on the face of the agreement Diamond appeared to receive only a right to share in profit (loss) to be derived, the value of the real estate could have been substantially greater than the purchase price, so that Diamond could really have had an interest in capital, if the assets were properly valued. This finding was not made. The Tax Court, 56 T.C. at 547, n. 16, suggested the possibility that Diamond was not in any event entitled to capital gains treatment of his sale of a right to receive income in the future, but did not decide the question.

The court stated that taking matters at face value, the taxpayer received, on February 18, an interest in partnership, limited to a right to a share of profit (loss) to be derived. This interest was referred to either his interest in partnership or a profit share.

The court stated that the Tax Court, with clearly adequate support, found that Diamond's interest in partnership had a market value of $40,000 on February 18. The taxpayer's analysis was that under the regulations the receipt of a profit share February 18, albeit having a market value and being conferred in return for services, was not a taxable event, and that the entire proceeds of the March 8 sale were a capital gain. The Tax Court analysis was that the interest in partnership, albeit limited to a profit share, was property worth $40,000, and the taxpayer's acquisition, thereof on February 18 was

compensation for services and ordinary income. The court stated that, assuming that capital gain treatment at sale would have been appropriate, there was no gain because the sale was for the same amount.

There was no statute or regulation which expressly and particularly prescribed the income tax effect, or absence of one, at the moment a partner received a profit share in return for services. The Tax Court's holding rested upon the general principle that a valuable property interest received in return for services was compensation, and income. The taxpayer's argument was predicated upon an implication which his counsel, and others, found in Section 1.721-1(1)(b) of the Treasury Regulations, but which need not, and the government argued should not, be found there.

The court stated that Section 721 was entitled "Nonrecognition of gain or loss on contribution," and provided "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partner-ship." The court stated that, only if, by a strained construction, "property" were said to include services, would Section 721 say anything about the effect of furnishing services. The court stated that it clearly pertained to a contribution like Kargman's, of property, and prescribes that when he contributed his property, no gain or loss was recognized. It did not, of course, explicitly say that no income accrued to one who renders services and, in return, became a partner with a profit share.

The court stated that Section 1.721-1 of the Treasury Regulations presumably explained and interpreted Section 721, perhaps to the extent of qualifying or limiting its meaning. Section 10721-1(b(1), particularly relied on in the case, read in part as follows:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partner-ship capital so transferred to a partner as compensation for services constitutes in-come to the partner under section 61 ... .

The court stated that the quoted portion of the regulation could be read, like Section 721, as being directly addressed only to the consequences of a contribution of money or other property. It asserted that when a partner making such contributions transferred to another some part of the contributing partner's right to be repaid, in order to compensate the other for services or to satisfy an obligation to the other, Section 721 did not apply, there was recognition of gain or loss to the contributing partner, and there was income to the partner who received, as compensation for services, part of the right to be repaid.

The court stated that the regulation did not specify that if a partner contributing property agreed that, in return for services, another would be a partner with a profit share only, the value of the profit share was not income to the recipient. An implication to that effect, such as was relied on by taxpayer, had to rest on the proposition that the regulation was meant to be all inclusive as to when gain or loss was recognized or income existed as a consequence of the contribution of property to a partnership and disposition of the partnership interests. It had to appear, in order to sustain such implication, that the existence of income by reason of a creation of a profit share, immediately having a determinable market value, in favor of a partner had to be inconsistent with the result specified in the regulation.

The court stated that it did not find this implication in reading the regulation. It became necessary to consider the substantial consensus of commentators in favor of the principle claimed to be implied and to look to judicial interpretation, legislative history, administrative interpretation, and policy considerations to determine whether the implication was justified.

The court stated that there was a startling degree of unanimity that the conferral of a profit-share as compensation for services was not income at the time of the conferral, although little by way of explanation of why this was so, or analysis of statute or regulation to show that it was prescribed.

The court stated that one of the most unequivocal statements, with an explanation in terms of practicality or policy, was made by Arthur Willis:

> However obliquely the proposition is stated in the regulations, it is clear that a partner who receives only an interest in future profits of the partnership as compensation for services is not required to report the receipt of his partnership interest as taxable income. The rationale is two-fold. In the first place, the present value of a right to

> participate in future profits is usually too conjectural to be subject to valuation. In the second place, the service partner is taxable on his distributive share of partnership income as it is realized by the partnership. If he were taxed on the present value of the right to receive his share of future partnership income, either he would be taxed twice, or the value of his right to participate in partnership income must be amortized over some period of time.

The court stated that except for one statement by the Tax Court no decision cited by the parties or found by the court appeared squarely to reach the question, either on principle in the absence of the regulations, or by application of the regulations. In a footnote in *Hale v. C.I.R.*, T.C. Memo. 1965-274, 1965 WL 1045 (T.C. 1965) the Tax Court said: "Under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. Sec. 1.721-1(b), Income Tax Regs." There was no explanation of how this conclusion was derived from the regulations.

An advisory group appointed in 1956 to review the regulations evidently felt concern about whether the provision of Section 1.721-1 of the Treasury Regulations that the value of an interest in capital transferred to a partner in compensation for services constituted income had a statutory basis in the light of Section 721 providing that there was no recognition of gain or loss in the case of a contribution of property. The group proposed enactment of a new section to provide such basis, and legislation introduced into the 86th Congress in 1959 incorporated this recommendation. The bill, H.R. 9662, would have created a new Section 770 providing specifically for the taxation of a person receiving an interest in partnership capital in exchange for the performance of services for the partnership. The court stated that, however, neither proposed Section 770 nor anything else in H.R. 9662 dealt with the receipt merely of a profit share. The lack of concern over an income tax affect when only a profit share was conferred could have implied an opinion that such conferring of a profit share was not taxable under any circumstances, or might imply an opinion that it was income or not under Section 61 depending upon whether it had a determinable market value or not.

The court stated that several statements in the course of the hearings and committee reports paralleled the first parenthetical phrase in Section 1.721-1(b) of the Treasury Regulations and were to the effect that the provision did not apply where a person received only a profit share. There was, however, at least one specific statement by the chairman of the advisory group (Mr. Willis) that if the service

partner "were to receive merely an interest in future profits in exchange for his services, he would have no immediate taxable gain because he would be taxed on his share of income as it was earned." H.R. 9662 passed the House of Representatives, and was favorably reported to the Senate by its finance committee, but never came to a vote in the Senate.

The court said that it was unaware of instances in which the Commissioner had asserted delinquencies where a taxpayer who received a profit share with determinable market value in return for services failed to report the value as income, or had otherwise acted consistently with the Tax Court decision in Diamond. Although the consensus referred to earlier appeared to exist, the Commissioner had not by regulation or otherwise acted affirmatively to reject it, and in a sense might be said to have agreed by silence.

The court said that there was required to be a wide variation in the degree to which a profit-share created in favor of a partner who had or would render service had determinable market value at the moment of creation. Surely, in many if not the typical situations it would have only speculative value, if any.

The court said that, in this case, the taxpayer's services had all been rendered, and the prospect of earnings from the real estate under Kargman's management was evidently very good. The profit share had determinable market value.

If the decision was sound, then the question would always arise, whenever a profit-share was created or augmented, whether it had a market value capable of determination. Would the existence of this question be unduly burdensome on those who choose to do business under the partnership form?

The court said that each partner determined his income tax by taking into account his distributive share of the taxable income of the partnership. The taxpayer's position in this case was that he was entitled to defer income taxation on the compensation for his services except as partnership earnings were realized. If a partner was taxed on the determinable market value of a profit share at the time it was created in his favor, and was also taxed on his full share of earnings as realized, there was arguably double taxation, avoidable by permitting him to amortize the value which was originally treated as income. The court raised the question: Did the absence of a recognized procedure for amortization militate against the treatment of the creation of the profit share as income?

The court asked whether the disadvantages of treating the creation of the profit share as income in those instances where it had a determinable market value at that time outweigh the desirability of

imposing a tax at the time the taxpayer had received an interest with determinable market value as compensation for services?

The court concluded that it thought, of course, that the resolution of these practical questions made clearly desirable the promulgation of appropriate regulations, to achieve a degree of certainty. But in the absence of regulation, the court stated that it thought it sound policy to defer to the expertise of the Commissioner and the Judges of the Tax Court, and to sustain their decision that the receipt of a profit share with determinable market value was income.

The court stated that Diamond's final argument in the 1962 partnership case was that he was entitled under Section 702 to a deduction not claimed on his return: his share of the partnership's loss resulting from unamortized loan expense. The Tax Court rejected the claim because the record failed to show whether there was income during the period prior to the sale, and thus failed to establish the existence and amount of partnership loss.

Apparently, the Tax Court understood that Diamond was referring to the $33,000 paid to the lender as unamortized loan expense. In this case, Diamond argued that the figure should have been $73,000, theorizing that if the value of his profit share at the time of creation was $40,000, and compensation to him for services to the partnership, $40,000 should also be added to the unamortized loan expense.

The court stated that whichever figure was appropriate, it agreed with the Tax Court's reasoning, noting also that there were additional reasons why Diamond was not entitled to a deduction for a share of partnership unamortized loan expense: (i) the sale of the petitioner's interest did not effect a termination under Section 708(b) (1) (B), the petitioner was entitled to a 60 percent share only after restoration to Kargman of $78,195.33, even if the value of Diamond's interest was $40,000, it was substantially less than 50 percent of the total interest in partnership capital and profits; and (ii) if statutory termination were to have occurred, it would have taken place after and not before the sale, the unamortized loan expenses would have passed to the new partners and the new partnership, not to petitioner.

Before 1961 Diamond had earned his living as a builder. In the course of this activity he became acquainted with Henry Moravec, Jr. and Henry Moravec, Sr., the principal officers of Marshall Savings and Loan. The Moravecs suggested that Diamond serve as a mortgage broker for Marshall. Diamond was to find builders in need of funds and arrange for them to receive loans from Marshall. Diamond would charge the builders a fee for arranging these loans. However, he paid a portion of these fees to the Moravecs. During 1961, Diamond received

commissions totaling $145,186.37 and remitted $39,398.50 to the Moravecs.

On his 1961 return, Diamond included $145,186.37 in income but deducted the $39,398.50 as an ordinary and necessary business expense. Alternatively, he maintained that the $39,398.50 should not have been included in gross income in the first place because he received these fees merely as a conduit for the Moravecs.

The Tax Court considered and rejected both the deduction and the conduit theories. The court found that Diamond had failed to prove that he had received this money as a conduit and not under a claim of right. The court also found that Diamond had failed to prove that this type of payment to the lender's officers was ordinary and necessary. The court found that the findings were not clearly erroneous, and the Tax Court's conclusions therefrom were correct.

The court ruled that the judgments of the Tax Court in both the 1962 partnership and the 1961 commissions case were affirmed.

### *ST. JOHN V. UNITED STATES*, NO. 82-1134 (C.D. ILL., NOVEMBER 16, 1983)

In *St. John v. United States*, No. 82-1134 (C.D. Ill., November 16, 1983), the court addressed the question of whether a partnership interest was a profits interest or capital in nature for purposes of valuing the taxpayer's interest.

In 1982, the plaintiffs filed suit against the United States seeking a refund of income taxes paid for the calendar year ending December 31, 1976. The plaintiffs claimed that the IRS erroneously included $25,500 in the plaintiffs' gross income by virtue of Donald B. St. John's receipt of a 15 percent interest in the Stark County Health Center partnership. The plaintiffs were assessed $11,567.16 representing an additional tax, penalty, and interest. After a trial before this court on September 15, 1983, this court found that the Stark County Healty Center partnership became a partnership under Illinois law in 1975. The court ruled that the 15 percent partnership interest received by the plaintiff Donald B. St. John was in 1975 subject to a substantial risk of forfeiture, as defined in Section 83 of the Internal Revenue Code of 1954 and Section 1.83-3(c) of the Treasury Regulations. By the end of 1976, the partnership interest was not subject to a substantial risk of forfeiture. The additional income received by the plaintiffs in the form of a partnership interest was therefore properly assessed against them for the taxable year 1976. This court also ruled that assessment of a negligence penalty against the plaintiffs pursuant to Section 6653(A) of the Code was improper.

This court found that the partnership interest received by St. John was not capital in nature, but rather was a profit/loss interest as a result of the oral agreement between St. John and the other partners. The partners orally agreed that St. John would receive nothing upon liquidation of the partnership unless and until the other partners first received their initial cash contributions (collectively $170,000). This court reserved ruling on the issue of the fair market value of the 15 percent interest and requested briefs from both parties.

The defendant in its brief argued that the plaintiffs failed to overcome the presumption that the fair market value of St. John's partnership interest was $25,500. "Fair market value" was defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts" under Section 20.2031-1(b) of the Treasury Regulations. A federal tax assessment, the defendant asserted, was presumed to be correct and a taxpayer had the burden of proof to establish that the assessment was incorrect. *U.S. v. Janis*, 428 U.S. 433, 440-41, 96 S. Ct. 3021, 49 L. Ed. 2d 1046 (1976)United States v. Janis [76-2 USTC ¶16,229], 428 U.S. 433, 440–41 (1976). The taxpayer's burden had been described as a "double burden of proof" for a taxpayer because, in addition to proving that the assessment was erroneous, he had to also prove that the United States owed him a specific amount of money as a refund. See *Timken Roller Bearing Co. v. U.S.*, 38 F.R.D. 57 (N.D. Ohio 1964); *Crosby v. U.S.*, 496 F.2d 1384, 1390 (5th Cir. 1974). The defendant alleged that the plaintiffs failed to introduce any evidence on the question of the "fair market value" of St. John's interest in that the testimony presented by the plaintiffs related only to the value of St. John's interest upon liquidation. The issue was not, however, the defendant asserted, the "liquidation value" but rather the "fair market value", and since the plaintiffs presented no evidence as to the value a willing buyer and a willing seller would have placed on the interest, their argument failed.

The defendant suggested in a footnote that tax losses were marketable commodities in that partners were entitled to report losses on their personal income tax returns. The fact that a buyer could have purchased a tax loss, the defendant claimed, reflected favorably on the fair market value of the partnership interest. The plaintiffs replied that St. John was not entitled to his share of the loss, and the IRS expressly denied such loss in 1976. Second, the plaintiffs asserted, tax losses had value only if they were ultimately offset by profits. This court adopted the position and arguments of the plaintiff on this issue.

Agent Jerry Brune testified for the defendant that the IRS, when it determined the "fair market value" of a partnership interest received in exchange for services, computed the estimated fair market value of the services that were rendered. Brune stated that one of the best ways of determining this value was to multiply the total capital in the partnership by the percentage of the partnership interest received. Brune testified that based upon existing case law, it made no difference in computing the fair market value of St. John's interest whether he received an interest in partnership capital or a profit/loss interest. The defendants placed some reliance on *Diamond v. C. I. R.*, 492 F.2d 286 (7th Cir. 1974) *Diamond v. C. I. R.*, 492 F.2d 286 (7th Cir. 1974). In Diamond, the Seventh Circuit considered the issue of the value of a partnership interest received in exchange for services rendered. The tax court refused to accept the taxpayer's argument that since he received only an interest in the partnership's profits and losses, he did not receive income subject to tax pursuant to Section 721 of the Internal Revenue Code of 1954 (26 U.S.C.) and the regulations thereunder. The tax court held that the fair market value of the taxpayer's interest, whether a capital or a profit/loss interest, was includable in his income and upheld the assessment.

The court said that the plaintiffs suggested that there was substantial evidence in the record that, because of the specific nature of St. John's interest, it had a market value as of December 31, 1976, of zero. They argued that there was no evidence in the record to support a finding of a value of $25,500, and thus, the defendant's only position was to try to refute the evidence of value which was presented at trial. The plaintiffs asserted that witnesses for both parties indicated that the proper method for a determination of the value of the partnership interest was based on its liquidation value. Brune, the plaintiffs asserted, testified as to the routine procedures of the IRS in determining the value of a partnership interest. That method was to take the liquidation value of such interest, *i.e.,* each partner's ratable share of the partnership assets. The court said the obvious fallacy of the determination of the IRS, the plaintiffs claimed, was that the IRS failed to take into account the fact that St. John's interest was different from the other partners in that St. John would receive no portion of the first $170,000 in liquidation. Agent Brune admitted that the value of the partnership interest would be directly affected to the extent it had subordinate rights in liquidation.

Orville Frank, a certified public accountant, testified at trial on at least five occasions that the value of St. John's interest as of December 31, 1976, was zero. Frank, therefore, did not include a specific value for the interest on the 1976 income tax return. The primary basis

for Frank's opinion, the plaintiffs asserted, was that St. John would get nothing in liquidation as of the end of 1976. Additional factors affecting Frank's opinion were that St. John's interest was not a capital interest, the nursing home was not in operation as of the end of 1976 nor was it even licensed, and some of the facility's original capital had already been spent. The plaintiffs concluded that Frank's testimony did not necessarily equate market value with liquidation value, but that as a result of the liquidation value and other factors, the value of St. John's interest was zero. St. John concurred in Frank's opinion.

The plaintiffs argued that all three witnesses effectively determined value by determining the amount of money St. John would have received had the partnership dissolved and the assets been liquidated and distributed. This was precisely the method Brune said was routine for valuing a partnership interest, the plaintiffs asserted, inasmuch as he merely took a pro rata share (15 percent) of the partnership assets ($170,000) in determining the value of St. John's interest. Brune, however, the plaintiffs claimed, failed to consider the particular liquidation characteristics of St. John's interest as a result of St. John's agreement with the partners that his interest was subordinate. On December 31, 1976, the partnership had assets worth less than $170,000 and thus on liquidation St. John would have received nothing.

The court said that courts have given effect to the liquidation value of property as its market value for tax purposes in several cases where the factual circumstances warranted such an approach. In *Estate of Garrett v. Commissioner, T.C.M.* (P-H) P 53329, 12 T.C.M. (CCH) 1142, 1953 WL 10620 (T.C. 1953), for example, this court looked at the liquidation value of certain property as its market value where a logging company had long ceased to be active, its equipment was antiquated and its supply of timber nearly exhausted. In *Learner v. Commissioner* [CCH Dec. 39,946(M)], 45 TCM 92 (1983), this court adopted the liquidation method for determining value of petitioner's minority interest where there were reasonable prospects that the company would be liquidated. The value of the business was viewed as that of its underlying assets. *Berckmans v. C. I.R.*, T.C. Memo. 1961-100, 1961 WL 992 (T.C. 1961), involved an inactive and unproven corporation where numerous contingencies indicated that the corporation could acquire ongoing businesses or that it could remain nothing but a shell. This court in that case ruled that the value of the stock at the date of its sale was not greater than its book value since the business outlook of the corporation was uncertain.

The plaintiffs argued that *Estate of Lee v. Commissioner of Internal Revenue*, 69 T.C. 860, 1978 WL 3312 (1978) was analogous

to the situation in this case. In Lee, a husband and wife had formed a corporation which had 50,000 shares of preferred and 5,000 shares of common stock. The preferred was entitled to a $200 per share preference in liquidation. In deciding the value of the preferred shares, this court allocated nearly all the value of the corporation to the preferred. The court said:

> The common shareholders were entitled to no distribution until the corporation had sufficient assets to meet the $10,000,000 (liquidation preference) value. This potential return to common shareholders was speculative and could be anticipated to occur, if at all, only many years later.

Thus, this court looked at the factual circumstances underlying the value of the stock in determining its fair market value.

The court said that the Diamond case, on which the defendant relied, was distinguishable from this case. In Diamond, it was clear that the interest involved did have a value since within 30 days of receipt of the interest, it was sold for $40,000. This did not mean, however, that all profit interests had a substantial market value. In discussing the value of a profit interest, the Seventh Circuit noted that:

> There must be wide variation in the degree to which a profit-share created in favor of a partner who has or will render service has determinable market value at the moment of creation. Surely in many if not the typical situations it will have only speculative value, if any.

492 F.2d at 290.

In discussing the value to be allocated to the interest in Diamond, the Seventh Circuit noted that there is no statute or regulation which expressly prescribes the income tax effect at the moment a partner receives a profit-share in return for services. The court in Diamond noted that:

> There is a startling degree of unanimity that the conferral of profit-share as compensation for services is not income at the time of the conferral, although little by way of explanation of why this should be so, or analysis of statute or regulation to show that it is prescribed.

492 F.2d at 289.

Commentator Willis suggested that:

> However obliquely the proposition is stated in the regulations, it is clear that a partner who receives only an interest in future profits of the partnership as compensation for services is not required to report the receipt of his partnership interest as taxable income. The rationale is two-fold. In the first place, the present value of right to participate in future profits is usually too conjectual to be subject to valuation. In the second place, the service partner is taxable on his distributive share of partnership income as it is realized by the partnership. If he were taxed on the present value of the right to receive his share of future partnership income, either he would be taxed twice, or the value of his right to participate in partnership income must be amortized over some period of time.

Willis on Partnership Taxation, 84-85 (1971), as quoted in Diamond, 492 F.2d at 289. It is also noted in McKee, Nelson and Whitmire, Federal Taxation of Partnerships and Partners, ¶5.06 at 5–32 (1977), that "many profit interests will be virtually valueless when received."

The court said that Section 83 of the Code required it to determine the fair market value of St. John's interest as of December 31, 1976. The fair market value was defined as the price at which the property would change hands between a willing buyer and a willing seller, both having reasonable knowledge of relevant facts under Section 20.20311(b) of the Treasury Regulations. Thus, the issue to be resolved in this case was what a willing buyer would pay St. John for his subordinated interest in the partnership. Based on this court's determination that St. John's interest was merely a profit interest and was different from the capital interests that the other partners had, the court had to look beyond St. John's pro rata share of 15 percent in the partnership assets of $170,000 in determining the value of St. John's interest.

In 1976, the nursing home's success was undetermined and speculative. It was not licensed nor operational and the partnership operated at a loss of $26,140 for that year. It was not clear when, if ever, the partnership would be profitable. Thus, the liquidation approach to value was the proper method for determining the fair market value of St. John's subordinate interest in the partnership.

The court said the burden of proof was clearly on the plaintiffs to establish that determination of their tax liability by the IRS was incorrect. The plaintiffs met this burden and proved the amount of refund due. They established, based on both testimony at trial and

legal authority, that St. John had merely a profit interest and that the liquidation method was the proper one for determining the value of that interest. They showed that the defendant's determination of a value of $25,500 was erroneous in that it failed to consider that St. John's interest was merely a profit interest. St. John's interest had a value of zero for the taxable year 1976 since he would receive nothing in liquidation on December 31, 1976.

The court ruled in favor of the plaintiffs in the amount of $11,567.15, plus interest.

### *CAMPBELL v. C.I.R.*, 943 F.2D 815 (8TH CIR. 1991)

In *Campbell v. C. I. R.*, T.C. Memo. 1990-162, 1990 WL 32763 (1990), the Eighth Circuit Court of Appeals reversed the United States Tax Court's holding that the taxpayer's interests were taxable upon receipt and agreed with the taxpayer that "[a]ny predictions as to the ultimate success of the operations were speculative." The court also stated that "[the taxpayer's] interests were not transferrable and were not likely to provide immediate returns." The court held that the interests "were without fair market value at the time [the taxpayer] received them and should not have been included in his income for the years in issue." The court agreed with the Tax Court's comment that fair market value is "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed of all the relevant circumstances."

In Campbell, the appellants, husband, and wife, requested a review of a decision of the Tax Court which held that the husband's partnership profits interests constituted income and therefore the appellants had to pay taxes on that income when they filed their joint return.

The appellants contested taxes assessed to them by appellee, Commissioner of the Internal Revenue Service. The tax court found that partnership profit interests received by appellant husband constituted income. The appellant husband had received these partnership profit interests for services rendered to various real estate partnerships. The appellants argued that the husband did not receive any income from these profit interests because the partnerships were speculative in nature and it was not known whether any profits would ever be realized on these interests. The tax court assessed a value to the profit interests and held that appellants should have declared them as ordinary income. The appellate court reversed the ruling of the lower

court, holding that the profit interests were extremely speculative and that appellants had not received any income from these interests.

Prior to and during the years in issue, William Campbell was employed by Summa T. Group, a collection of business entities involved in the formation and syndication of limited partnerships. Campbell served as vice president and director for most members of the Summa T. Group, including Summa T. Realty, Inc., a real estate brokerage and consulting firm. He also served as vice president of Realty Properties Company, another member of Summa T. Group. Most of Campbell's services during these years were performed for *Campbell v. C. I. R.*, T.C. Memo. 1990-162, 1990 WL 32763 (1990).

In partnership with Jim Nettles, another Summa T. Realty employee, Campbell packaged and sold interests in transactions on behalf of Summa T. Realty. Campbell, T.C. Memo. 1990-162. Nettles left Summa T. Realty in 1979, and Campbell became responsible "for locating suitable properties for Summa T. Realty, negotiating the acquisition of those properties, obtaining the financing necessary to acquire the properties, organizing the partnerships which would eventually acquire those properties, and assisting in the preparation of offering materials in connection with the syndication of those partnerships." Campbell, T.C. Memo. 1990-162. Following Nettles's departure, Campbell negotiated a new compensation agreement under which he received 15 percent of the proceeds from each syndication and, for his services, special limited partnership interests (profits interests) in the partnerships that he helped form and finance. Campbell, T.C. Memo. 1990-162. Campbell sought these interests because of the immediate tax benefits he would receive and the residual value they might have. Based on consultation with two tax attorneys, he believed that the receipt of these interests in exchange for services would not be taxable events, at the time of acquisition. Campbell, T.C. Memo. 1990-162.

Campbell performed services in the formation and syndication of three limited partnerships. In 1979, he received a 2 percent special limited partnership interest in Phillips House Associates, Ltd. Campbell, 59 T.C.M. (CCH) at 238. Realty Properties was the sole general partner in Phillips House, and David Kane, president of Realty Properties, was also a special limited partner. Campbell, 59 T.C.M. (CCH) at 237–38. Phillips House was formed to purchase, renovate, and operate a hotel in downtown Kansas City, Missouri. The offering memorandum, which was provided to potential investors in the 35 Class A limited partner units available for sale, predicted losses for tax purposes from 1979 to 1985, 94 percent allocated to the limited partners and 2 percent allocated to each special limited partner and

the general partner. Campbell, 59 T.C.M. (CCH) at 238–39. However, the memorandum warned that an Internal Revenue Service audit was likely. And, it was predicted that the IRS probably would disallow some or all of the deductions and allocations. Campbell, 59 T.C.M. (CCH) at 239.

Twenty Class A interests were sold by December 31, 1979, and the remaining 15 were sold by December 31, 1980. Campbell, 59 T.C.M. (CCH) at 240. Each unit sold for $99,250. Campbell, 59 T.C.M. (CCH) at 238. Resale of partnership units was subject to approval by the general partner, which could withhold approval arbitrarily. Campbell, 59 T.C.M. (CCH) at 240. The partnership did not anticipate cash distributions to the Class A limited partners until 1982 and to the special limited partners and the general partner until 1984. Campbell, T.C. Memo. 1990-162. Once cash became available for distribution, the Class A limited partners were given priority. Campbell, 59 T.C.M. (CCH) at 239. They were also entitled to a return of their capital investment upon the sale or refinancing of the hotel. The first $30,000 of any additional proceeds from such a transaction was allocated to the general partner as return of capital. The special limited partners were each entitled to a share of any remaining proceeds. Campbell, 59 T.C.M. (CCH) at 240.

Diversified Financial Services, a member of Summa T. Group, received 3 percent of the Phillips House offering proceeds as reimbursement for expenses incurred in the offering. Campbell, 59 T.C.M. (CCH) at 238. Realty Properties, and other members of the group, received 42.5 percent of the proceeds for "expense allowances, consulting fees, and management fees." Campbell, 59 T.C.M. (CCH) at 238–239. Campbell provided services in the formation and syndication of the partnership. However, the record did not reveal what part of these fees were paid to Summa T. Group for services actually performed by Campbell, nor did it reveal what part of Campbell's partnership interest, if any, was received as compensation for services for which his employer was compensated.

The other two limited partnerships at issue here were formed under similar agreements. Campbell received a 1 percent interest in The Grand partnership, which was formed in 1980 to purchase and operate the Howard Johnson's Motor Lodge in Myrtle Beach, South Carolina. Campbell, 59 T.C.M. (CCH) at 238, 241. Also in 1980, the Airport partnership was formed to purchase and operate the Northwest Airport Inn in St. Louis County, Missouri. Campbell, 59 T.C.M. (CCH) at 244. Campbell received a 1 percent interest in Airport. Campbell, 59 T.C.M. (CCH) at 238. As in Phillips House, Realty Properties was the general partner, Campbell and Kane were

special limited partners, and 35 Class A limited partnerships were sold in both The Grand and Airport. Campbell, 59 T.C.M. (CCH) at 241–242, 244. Realty Properties and its affiliates, including Diversified Financial Services and Summa T. Realty, received 30.2 percent of the proceeds of The Grand's offering of limited partnership interests, Campbell, 59 T.C.M. (CCH) at 242, and 38.5 percent of the proceeds of Airport's offering Campbell, 59 T.C.M. (CCH) at 244. These payments were made for expense allowances, consulting fees, management fees and financing fees. The court stated that, Campbell provided some of these services, and the record did not reveal the capacity in which he performed them. Campbell, 59 T.C.M. (CCH) at 242, 244. The offering memoranda for The Grand and Airport projected taxable losses for the first several years of operations. As with Phillips House, however, the memoranda warned that any of the deductions and credits might be disallowed by the Internal Revenue Service. Campbell, 59 T.C.M. (CCH) at 242, 245.

On May 10, 1983, the Commissioner issued a notice of deficiency for the tax years 1979 and 1980, alleging that Campbell should have included the value of his interests in these partnerships in ordinary income. Campbell, 59 T.C.M. (CCH) at 247. The Commissioner valued Campbell's interests in Phillips House, The Grand and Airport at $42,084, $16,968 and $20,683, respectively. Campbell, T.C. Memo. 1990-162. In an amendment to his answer, the Commissioner alleged that Campbell was liable for additions to tax for, inter alia, negligently failing to include these interests in his ordinary income.

The tax court upheld, in part, the Commissioner's assessment of deficiency and addition to tax. The court agreed that the fair market value of the profits interests should have been included in Campbell's income. The court, however, did not fully agree with the Commissioner's valuation of the interests. Upon revaluation, the court sustained the Commissioner's deficiency in regard to The Grand. The court valued Campbell's interest in Airport at $15,000 and his interest in Phillips House at $25,000 and entered an order accordingly. Campbell, 59 T.C.M. (CCH) at 256.

Campbell argued on appeal, as he did unsuccessfully in the tax court, that a service partner (*i.e.,* a partner who receives his partnership interest in exchange for services provided to the partnership) who received a profits interest (*i.e.,* a right to share in profits and losses only, as opposed to an interest in the capital assets of a partnership) in a partnership did not realize income upon receipt of that interest, and, therefore, no taxable event occurred. In the alternative, he argues that the interests he received had no value at the time he received them and, thus, he should not have been taxed.

At this point, the Commissioner conceded that the tax court erred in holding that the receipt of a profits interest in exchange for services to the partnership should be considered ordinary income to the service provider. However, the Commissioner asserted that Campbell actually received the partnership interests in exchange for services he provided to his employer, rather than services he provided to the partnerships. According to the Commissioner, the tax court held that Campbell received the interests as compensation from his employer. Thus, he was not a service partner; the principles of partnership taxation did not apply; and Campbell's receipt of compensation from his employer was taxable upon receipt.

The court made short work of the Commissioner's alternate argument. The court stated that it could affirm a trial court's decision on any ground supported by the record, whether or not that ground was addressed by the lower court. *See Brown v. St. Louis Police Dept. of City of St. Louis*, 691 F.2d 393, 396–397 (8th Cir. 1982) (when issue was raised but not addressed by the district court and did not require factual findings, appellate court could affirm based on that issue), cert. denied, 461 U.S. 908, 103 S. Ct. 1882, 76 L. Ed. 2d 812 (1983). The court stated that such action, however, was inappropriate in this case. The court stated that the Commissioner's argument, at best, required that the court resolve a disputed question of fact. Contrary to the Commissioner's belief, the tax court did not hold that Campbell received his partnership interests for services he performed for his employer rather than services performed for the partnerships. In reaffirming *Diamond v. C. I. R.*, 492 F.2d 286 (7th Cir. 1974), the court held "that Section 721(a) and the regulations thereunder are simply inapplicable where, as in the Diamond case and the instant case, a partner receives his partnership interest in exchange for services he has rendered to the partnership." Campbell, 59 T.C.M. at 249. The court also noted the records of the partnerships indicated that Campbell received the partnership interests after rendering services. Campbell, 59 T.C.M. (CCH) at 249. The Commissioner tenuously relied on the tax court's statements that Campbell received his partnership interests in connection with services provided for his employer. Campbell, 59 T.C.M. (CCH) at 251–253. The statements were made in the discussion of when Campbell received his interests. The court believed that the tax court did not specifically hold that the interests were received as payment for services provided to his employer. In any event, the court declined to address the factual matter and the court disregarded the argument.

The court stated that although the Commissioner conceded the tax court's error in taxing a service partner's profits interest, the tax

court's holding was not without support. In fact, the only circuit court to address the issue arrived at the same conclusion. See Diamond, 492 F.2d 286. However, Campbell and several amici curiae argued that the tax court's decision did substantial damage to established principles of partnership tax law. In addition, several commentators had analyzed the issue and came to a variety of conclusions. Compare, *e.g.*, Hortenstine & Ford, Receipt of a Partnership Interest For Services: A Controversy That Will Not Die, 65 Taxes 880, 881 (1987) (Generally, the fair market value of a profits interest received by a service partner should be included in income.) and C. Bishop & J. Brooks, Federal Partnership Taxation 83–86 (1990) (Perhaps, when partnership income is very speculative, some profits interests should not be included in income.) with 1 W. McKee, W. Nelson, & R. Whitmire, Federal Taxation of Partnerships & Partners paras. 5.02[1][b], at 5-14, 5.02[1][c], at S5-2 to -3 (2d ed. 1990 & Supp. 2 1991) (The receipt of a profits interest is not a taxable event.) and A. Willis, T. Pennell, & P. Postlewaite, Partnership Taxation Section 46.12, at 46-36 (4th ed. 1991) (Although the ultimate result was uncertain, "the preferred tax treatment of the transfer of a profits interest as compensation for services is not to tax it at all."). Thus, the court was reluctant to accept the Commissioner's concession without substantive review.

The tax court rejected Campbell's contention that the regulations promulgated under Section 721 of the Internal Revenue Code and the general principles of partnership taxation exempted from taxation profits interests received in exchange for services. Campbell, 59 T.C.M. at 248–249. The court reaffirmed its holding that Section 721 and its regulations were "inapplicable where, as in the Diamond case and this case, a partner received his partnership interest in exchange for services he has rendered to the partnership." Campbell, 59 T.C.M. (CCH) at 249. The court stated that Section 721 related to contributions of property to partnerships, but not to contributions of services, which were not property within the meaning of that Section. Campbell, 59 T.C.M. (CCH) at 249. Section 721 was enacted to allow the contribution of property to a partnership without recognition of gain or loss. The rationale for non-recognition was that no disposition of property had occurred. Rather, the partnership interest represented a change in the form of the asset. The court stated that in case the tax court held that the receipt of profits interests represented compensation for services, not change in the form of assets. Campbell, T.C. Memo. 1990-162.

The court also noted the inconsistency in imposing immediate taxation upon a service partner who received a capital interest and not upon a service partner who received a profits interest, as Section 721 made no distinction between the two. Campbell, T.C. Memo.

1990-162. The court stated that the Section 721 regulations did not expand the scope of the statute to provide non-recognition of income to partners who contributed services in exchange for a partnership interest. Campbell, T.C. Memo. 1990-162. Thus, the tax court found no authority to support different treatment for capital and profits interests received in exchange for services and held that Campbell received ordinary income upon receipt of the profits interests.

The court stated that after finding that Campbell's receipt of the profits interests were taxable events, the court applied Section 83 to determine when the income should have been recognized. Campbell, 59 T.C.M. (CCH) at 249–250. The court stated that Section 83 provides rules governing when property received in connection with the performance of services must be recognized as income. Section 83(a) (1988). The regulations defined property to "include[] real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Section 1.83-3(e) of the Treasury Regulations (1985). The tax court had no doubt that a profits interest was property rather than a promise to pay money or property in the future. Campbell, 59 T.C.M. at 249–51. Furthermore, the court found no substantial risk of forfeiture. Thus, the interests were taxable upon receipt. See Campbell, 59 T.C.M. (CCH) at 252.

The tax court's holding was based principally on Diamond, and that case was analogous. However, to fully understand the concerns raised, the court stated that it was required to review several prior cases and the underlying statutory provisions. When a service partner received an interest in partnership capital, the cases held that a taxable event has occurred. The receipt of the capital interest was required to be included in the service partner's income. *See, e.g., U.S. v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964). See also W. McKee, supra, para. 5.01, at 5–2 (transfer of capital interest is taxable). The court state that as an interest in intangible personal property, the receipt of a capital interest appeared to be taxable under the authority of Section 83 of the Internal Revenue Code. There was little, if any, dispute that such a transaction involved the recognition of income.

The court stated that, as noted, however, when the service partner received solely a profits interest, the tax consequences were unclear. In contrast to Diamond, the tax court has held, and the Commissioner conceded in some cases, that receipt of a profits interest by a service partner created no tax liability. *See National Oil Co. v. C.I.R.*, T.C. Memo. 1986–596, 1986 WL 21807 (1986) (Commissioner conceded that if taxpayer received only profits interest, no taxable event had occurred); *Kenroy, Inc. v. C.I.R.*, T.C. Memo. 1984-232, 1984 WL

14487 (1984) (profits interest had no fair market value, thus no tax liability upon receipt); *Hale v. C.I.R.*, T.C. Memo. 1965-274, 1965 WL 1045 (T.C. 1965) ("Under the regulations, the mere receipt of a partnership interest in future profits does not create any tax liability. Sec. 1.721-(1)(b), Income Tax Regs.").

The court stated that the code did not expressly exempt from taxation a service partner's receipt of a profits interest, and the courts that have held that it was not taxed upon receipt did not appear to have closely analyzed the issue. However, the court noted that commentators developed three interrelated theories in support of the proposition that it is not a taxable event: (1) based upon regulation 1-721.1(b), a profits interest was not property for purposes of Sections 61 and 83; (2) a profits interest could have no fair market value; and (3) the non-realization concepts governing transactions between partner and partnership precluded taxation. *See, e.g.*, W. McKee, supra, paras. 5.01-.02[1], at 5-3 to -5; 5.02[2], at 5-15 to -18; 5.02[1][c], at S5-2 to -9.

The court stated that the tax court and the Seventh Circuit rejected at least the first two of these theories in Diamond. The tax court found that Diamond's receipt of a partnership profits interest in exchange for services was taxable as ordinary income did not come within the scope of Section 721 and had a readily ascertainable fair market value. The Seventh Circuit affirmed. Diamond, 492 F.2d at 286–87, 291. The facts in Diamond were very similar to those before this court, except in regard to the issue of value. Diamond had arranged the financing of a land purchase in exchange for a profits interest in the partnership that was to hold title to the land. Campbell, 59 T.C.M. (CCH) at 286–87. Diamond arranged the financing and received his partnership profits interest and then, three weeks later, sold his interest to a third party for $40,000. Campbell, 59 T.C.M. (CCH) at 287. Diamond treated the sale proceeds as short-term capital gain, which he offset by short-term capital loss. Campbell, T.C. Memo. 1990-162.

The court stated that the Seventh Circuit rejected Diamond's argument under regulation 1-721.1(b)(1), because it distinguished between receipt of a capital interest and a profits interest and specifically stated only that a service partner who received a capital interest was required to recognize income, implied that a service partner who received a profits interest did not recognize income. Campbell, 59 T.C.M. (CCH) at 288–89. The court noted that Section 721 applied only to those partners who contributed property to the partnership and that the application of the regulation was also so limited. Campbell, 59 T.C.M. (CCH) at 288. After considering other published views on the matter, the court declined to interpret the

regulation as Diamond proposed. Campbell, 59 T.C.M. (CCH) at 289–91. Although it affirmed the tax court, the Seventh Circuit noted the presence of strong views to the contrary, Campbell, 59 T.C.M. (CCH) at 289, and recognized the limitations of its holding:

> There must be wide variation in the degree to which a profit-share created in favor of a partner who has or will render service has determinable market value at the moment of creation. Surely in many if not the typical situations it will have only speculative value, if any.

Campbell, 59 T.C.M. (CCH) at 290.

The commentators generally agreed that the non-recognition principles of Section 721 did not apply to a service partner because a service partner did not contribute property in exchange for his partnership interest. *See, e.g.*, W. McKee, supra, para. 5.01, at 5–2. The court also agreed. However, the Section 721 regulations were relied upon to tax a service partner's receipt of a capital interest. And, as with a profits interest, a service partner who received a capital interest had not contributed property in exchange for his partnership interest. Thus, the Section 721 regulations provided some guidance when reviewing whether general principles of partnership taxation provide for non-realization in this case.

The court stated that Section 721 codified the rule that a partner who contributed property to a partnership recognized no income. Section 721. para. 5.02[1][c][ii], at S5-5. And, Section 1.721-1(b)(1) of the Treasury Regulations clarified that the non-recognition principles did no longer apply when the right to return of that capital asset was given up by transferring it to another partner. At that time, the property had been disposed of and gain or loss, if realized, must be recognized. As a corollary, Section 1.721-1(b)(1) outlined the tax treatment of the partner who received that capital interest. A substantial distinction, however, existed between a service partner who received a capital interest and one who received a profits interest. The court stated that when one received a capital interest in exchange for services performed, a shift in capital occurred between the service provider and the individual partners. *See* Section 721 para. 5.02[1][c][i], at S5-4; Hortenstine, supra, at 885–887. The court stated that the same was not true when a service partner received a profits interest. In the latter situation, prior contributions of capital were not transferred from existing partners' capital accounts to the service provider's capital account. Receipt of a profits interest did not create the same concerns because no transfer of capital assets was involved. The court stated

that the receipt of a profits interest never affected the non-recognition principles of Section 721. Thus, some justification existed for treating service partners who received profits interests differently than those who received capital interests.

The court stated that probably more relevant to the analysis in the discussion, however, was Section 707 of the Internal Revenue Code, which supported Campbell's argument. Section 707 (1988). Generally, a partner received a distributive share of income instead of compensation from his partnership. *See Pratt v. C. I. R.*, 550 F.2d 1023, 1026 (5th Cir. 1977) (salary payments to a partner treated as a distributive share of income); *C.I.R. v. Moran*, 236 F.2d 595, 598 (8th Cir. 1956) ("an individual cannot be his own employee nor can a partner be an employee of his own partnership"); *Lloyd v. C.I.R.*, 15 B.T.A. 82, 87, 1929 WL 669 (B.T.A. 1929) (same). Except under certain circumstances, "the general statutory policy for treating partnerships for tax purposes contemplated that the income of a partner-ship would flow through to the individual partners." Pratt, 550 F.2d at 1026. Only when the transaction was treated as one between the partnership and a partner acting in a non-partner capacity was the payment received by the partner not considered a distributive share. *See* Pratt, 550 F.2d. at 1026–1027; I.R.C. § 707(a)(2)(A). Section 707 created an exception to the general rule.

The court stated that Section 707 provided that when a partner engaged in a transaction with a partnership in a non-partner capacity that transaction would be treated as between the partnership and one who was not a partner. Section 707(a)(1). When a partner received payment for services performed for the partnership, that transaction fell under Section 707(a)(1) if "the performance of such services ... and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership." Pratt, 550 F.2d 1023, Section 707(a)(2)(A)(iii). The court stated that this exception was enacted to prevent partnerships from using direct allocations of income to individuals, disguised as service partners, to avoid the requirement that certain expenses would be capitalized. *See* W. McKee, supra, para. 5.02[1][b], at 5–13. However, it was not intended to apply when a service provider acted within his capacity as a partner. *See* Section 707(a)(2)(A)(iii). The court stated that, arguably, Section 707(a) would be unnecessary if compensatory transfers of profits interests were taxable upon receipt because, if so, every such transfer would be taxed without this section. *See* W. McKee, supra, para. 5.02[1][b], at 5-13 to -14.

The court stated that, in Diamond, where the service provider became a partner solely to avoid receiving ordinary income, the court stated that it doubted that the receipt of the profits interest was for services provided other than in a partner capacity. Diamond was likely to (and in fact did) receive money equal to the value of his services and apparently did not intend to function as or remain a partner. Thus, the receipt of his partnership profits interest was properly taxable as easily calculable compensation for services performed. Campbell's case, however, was not so clear. Campbell's interests were not transferable and were not likely to provide immediate returns. The court stated that it doubted that the tax court correctly held that Campbell's profits interests were taxable upon receipt.

The court stated that, more troubling, however, was Campbell's argument that the profits interests he received had only speculative, if any, value. The court fully agreed with this contention and reversed the tax court. As earlier noted by the tax court, "fair market value is "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy nor to sell and both being informed' of all the relevant circumstances." *See Palmer v. C. I. R.*, 523 F.2d 1308, 1310 (8th Cir. 1975) (quoting *Hamm v. C.I.R.*, 325 F.2d 934, 937 (8th Cir. 1963)). The court stated that while it reviewed de novo the basis of a fair market value determination, the ultimate question of value was one of fact. *See Estate of Palmer v. C.I.R.*, 839 F.2d 420, 423 (8th Cir. 1988).

Campbell's expert testified that the values of the partnership interests were speculative and not in excess of $1,000. His opinion was based on the present values of the cash distributions projected in the offering memoranda. He discounted these values because of the restrictions on transferability and the lack of participation rights in management of the partnerships. He attached no present value to the projected tax benefits because of the substantial risk of disallowance upon likely audits. The Commissioner used the same basic method of valuation, except that he included the present value of the tax benefits in his calculations and used a much lower discount rate resulting in higher present values.

The tax court accepted the method of valuation proposed by the parties, with some modifications. The court rejected Campbell's expert's opinion that the tax benefits were so speculative that they had no value and rejected the Commissioner's determination of the appropriate discount rate. Then, based on the present value of the tax benefits and future cash payments, reduced by the speculative nature of the Phillips House interest, the court valued the interests as

indicated above. Campbell, 59 T.C.M. at 254–256. Recognizing that the tax court's determination of value is a factual finding subject to clearly erroneous review, and that the tax court did not have to accept an expert's opinion as to value, see Palmer, 523 F.2d at 1310, the court was, nonetheless, left with the firm belief that the court's valuation was erroneous.

The tax court relied too heavily on the fact that Class A limited partners were willing to pay substantial sums for their interests at the same time Campbell received his interest. Because of the difference in the nature of the investments, the court believed that this fact was not relevant. The Class A limited partners had superior rights to cash distributions and return of capital, as well as some rights of participation. Furthermore, the court should not have disregarded the expert's belief that the tax benefits were speculative in nature. The partnerships were taking untested positions in regard to deductions and all of them were likely to be challenged and disallowed by the IRS. In fact, many of the deductions were ultimately disallowed. Furthermore, the predictions contained in the offering memoranda were just that—predictions. The partnerships had no track record. Any predictions as to the ultimate success of the operations were speculative. Thus, the court held that Campbell's profits interests in Phillips House, The Grand and Airport were without fair market value at the time he received them and should not have been included in his income for the years in issue.

The court concluded that the decision of the tax court holding that the Campbells should have included the receipt of profits interests in Phillips House, The Grand, and Airport in ordinary income in the year of receipt was reversed.

## TAX TREATMENT OF A PROFITS INTEREST

In IRS Revenue Procedure 93-27, 1993-2 CB 343 (June 9, 1993), the IRS announced that it would no longer challenge the compensatory grant of a profits interest as a tax-free transaction. The revenue procedure defined a "profits interest" as any interest in a partnership other than a "capital interest" and a "capital interest" as any interest "that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." To benefit from this self-imposed injunction, therefore, a partnership interest issued for services must have a "liquidation value" of zero on the date of grant.

In Revenue Procedure 93-27, the IRS said that, under Section 1.721-1(b)(1) of the Treasury Regulations, the receipt of a partnership

capital interest for services provided to or for the benefit of the partnership was taxable as compensation. On the other hand, the issue of whether the receipt of a partnership profits interest for services was taxable had been the subject of litigation. In *Campbell v. C.I.R.*, 943 F.2d 815 (8th Cir. 1991), the Eighth Circuit in dictum suggested that the taxpayer's receipt of a partnership profits interest received for services was not taxable, but decided the case on valuation. Other court determined that, in certain circumstances, the receipt of a partnership profits interest for services was a taxable event under Section 83 of the Code. *See, e.g., Campbell v. C.I.R.*, 943 F.2d 815 (8th Cir. 1991); *St. John v. United States*, No. 82-1134 (C.D. Ill. Nov. 16, 1983). The courts also found that typically the profits interest received had speculative or no determinable value at the time of receipt. *See* Campbell, 943 F.2d at 823; *St. John. In Diamond v. Commissioner of Internal Revenue*, 56 T.C. 530, 1971 WL 2461 (1971), however, the court assumed that the interest received by the taxpayer was a partnership profits interest and found the value of the interest was readily determinable. In that case, the interest was sold soon after receipt.

The IRS said that, other than as provided in the revenue procedure, if a person received a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS would not treat the receipt of such an interest as a taxable event for the partner or the partnership.

The IRS said that the revenue procedure did not apply if: (i) the profits interest related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (ii) within two years of receipt, the partner disposed of the profits interest; or (iii) the profits interest was a limited partnership interest in a "publicly traded partnership" within the meaning of Section 7704(b) of the Code.

The general partner of a private equity fund will usually subdivide the underlying carried interest of the fund by issuing separate grants of an interest therein to each of its partners. Unlike the grant to the general partner, the subdivided grants in the general partner will usually bear some form of vesting restriction. In Revenue Procedure 93-27, the IRS failed to address the impact (if any) of a vesting restriction on the initial grant of a profits interest. If Section 83 of the Internal Revenue Code applied to the grant of a profits interest for services, then any vesting restrictions on the date of grant would suspend the application of Revenue Procedure 93-27 until the restrictions lapse, at least absent a Section 83(b) election. Using this analysis, the grantee could make a "protective" Section 83(b) election on the date of grant, reporting the interest at a value of zero.

However, reconciling Revenue Procedure 93-27 with Section 83 were a Section 83(b) election to trigger an immediate tax would be difficult because the election would seek only to accelerate the tax consequences of Section 83(a) to the date of grant. Having concluded in Revenue Procedure 93-27 that Section 83(a) would not trigger an immediate tax upon grant of a fully vested profits interest, the IRS could hardly impose less favorable consequences to the recipient of an identical interest of lesser value.

Later, in Revenue Procedure 2001-43, 2001-2 CB 191 (August 3, 2001) the IRS again weighed in, finding no distinction between the grant of a vested interest and the grant of a non-vested interest. So long as the grant otherwise qualified under Revenue Procedure 2001-43, and the parties reported the grantee as a partner on the date of grant, the IRS would not challenge either the grant or vesting of a profits interest as a tax-free transaction.

Revenue Procedure 2001-43 clarified Revenue Procedure 93-27 by providing that the determination under Revenue Procedure 93-27 of whether an interest granted to a service provider was a profits interest was, under the circumstances described in the revenue procedure, tested at the time the interest was granted, even if, at that time, the interest was substantially non-vested (within the meaning of Section 1.83-3(b) of the Treasury Regulations). Accordingly, where a partnership grants a profits interest to a service provider in a transaction meeting the requirements of Revenue Procedure 2001-43 and Revenue Procedure 93-27, the IRS would not treat the grant of the interest or the event that caused the interest to become substantially vested (within the meaning of Section 1.83-3(b) of the Treasury Regulations) as a taxable event for the partner or the partnership. Taxpayers to which Revenue Procedure 2001-43 applied did not need to file an election under Section 83(b) of the Code.

Revenue Procedure 2001-43 clarified that, for purposes of Revenue Procedure 93-27, where a partnership granted an interest in the partnership that was substantially non-vested to a service provider, the service provider would be treated as receiving the interest on the date of its grant, provided that: (i) the partnership and the service provider treated the service provider as the owner of the partnership interest from the date of its grant and the service provider took into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider had the interest; (ii) upon the grant of the interest or at the time that the interest became substantially vested,

neither the partnership nor any of the partners deducted any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and (iii) all other conditions of Revenue Procedure 93-27 were satisfied.

In summary, the tax treatment of a profits interest: (i) the grant of the carried interest is a tax-free transaction; (ii) general partner of the fund will usually subdivide the underlying carried interest of the fund by issuing separate grants of an interest therein to each of its partners; (iii) the IRS will not generally challenge either the grant or vesting of a profits interest as a tax-free transaction.

The Treasury Department and the Internal Revenue Service have determined that, provided certain requirements are satisfied, it would be appropriate to allow partnerships and service providers to value partnership interests based on liquidation values. This would provide consistency in the treatment of partnership profits interests and partnership capital interests and regulations issued under subchapter K.

> For this purpose, the liquidation value of a partnership interest is the amount of cash that the holder of that interest would receive with respect to the interest if, immediately after the transfer of the interest, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of these assets, and then liquidated.

Subchapter K of the Internal Revenue Code measures each partner's relative share of the income and assets of a partnership from year to year by changes in capital accounts balances.

To validate an allocation, the Section 704(b) regulations generally require only that a partner be entitled to its positive capital account on or before a liquidation. If the partner receives a pure profits interest, subchapter K provides no place within the capital account regime to reflect the present value of the interest on a current basis. On May 24, 2005, the Department of Treasury issued proposed regulations regarding the application of Section 83 in the partnership context, which would apply to all compensatory grants of partnership interest on or after the date of the final regulations (which have not yet been issued); the regulations were an attempt to reconcile subchapter K, Section 83 and profits interest tax treatment. However, the IRS has not, and may not, issued any final regulations on this matter.

## A PROFITS INTEREST AND CAPITAL GAINS TREATMENT

Congress has not been without a voice with respect to the tax treatment of a profits interest. In 2010, carry interest legislation was proposed that would alter current law taxation of the profits interest. Under the legislation: the service provider would be required to report net income with respect to an "investment services partnership." The purpose of the proposed legislation was to convert all or substantially all of any income allocations to the general partner and the investors from long-term capital gain (or other investment income) into ordinary income: (i) re-characterize income as 50 percent ordinary income beginning in 2011 and as 75 percent ordinary income beginning in 2013; (ii) the tax rate of capital gains at 15 percent would then be considerably higher, as high as 29.8 percent in 2011 and 35.65 percent beginning in 2013.

The proposed legislation did not pass. However, the issue continues to be raised. Congress has believed that carried interest is not a passive holding but active management and therefore those interests should be not capital gains but ordinary income.

Controversial language that would raise taxes on carried interest, the share of profits that investment managers have been allowed to keep as compensation, will continue to be on the table for Congress. Prior legislation reflected the belief by critics that the money should be taxed at the higher ordinary income tax rates because it is actually a fee for services performed by investment managers. Revenue increases would result from a number of provisions in the tax extenders legislation including taxing as ordinary income a portion of the income of partners from performing investment management services (*i.e.,* carried interest) which was estimated to increase revenues by $19 billion over the 2010–2020 period.

The Tax Cuts and Jobs Act, Public Law No. 115-97 (the "Act"), signed into law by President Trump on December 22, 2017, added Section 1061 to the Internal Revenue Code to impose a three-year holding period, instead of a one-year holding period, in order to qualify for long-term capital gains treatment with respect to profits interests received in connection with the performance of services by the taxpayer for a partnership or limited liability company. Gains from profits interests held for three years or less are short-term capital gains subject to tax at ordinary income rates, which could be as high as 37 percent in 2018.

Section 1061 provides that, if one or more applicable partnership interests are held by a taxpayer at any time during the taxable year,

the excess (if any) of the taxpayer's net long-term capital gain with respect to such interests, over the taxpayer's net long-term capital gain with respect to such interests, computed by substituting "3 years" for "1 year." An "applicable partnership interest" is defined to include a profits interest granted in connection with performance of certain investment services, which is widely recognized as being intended to include "carried interest" compensation arrangements, which are common among private equity funds, hedge funds and similar investment partnerships.

Section 1061 applies to both gain from the sale of profits interests (*e.g.*, if the holder of the profits interest sells the profits interest to a third party for cash) and the gain allocated to a partner with respect to the profits interest to the extent the gain relates to the sale of assets held by the partnership or limited liability company (*e.g.*, if the holder of the profits interest does not sell the profits interest; and, instead, the underlying entity sells an asset for a capital gain and allocates some of that capital gain to the profits interest holder).

Accordingly, both of the following would be subject to tax at the taxpayer's ordinary income rate (and not eligible for capital gains treatment): (i) a profits interest holder's share of gain from the sale by the underlying entity of any assets (even a capital asset) disposed of by the underlying entity within the first three years of someone receiving the profits interest grant; or (ii) a profits interest holder directly selling the profits interest to someone before having held such interest for three years.

The IRS previously provided guidance with respect to the receipt of partnership profits interests and the potential recognition of income tax from such grant. Revenue Procedure 93-27 permits the recipient of a partnership profits interest to assign a zero value to the profits interest award on the date of grant, provided certain conditions are met. The conditions under Revenue Procedure 93-27 are: (i) the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets; (ii) the partner does not dispose of the profits interest within two years of receipt, and (iii) the profits interest is not granted by a publicly traded partnership. If the requirements of Revenue Procedure 93-27 are satisfied, any income allocated from the partnership will be the same for the service recipient as any other partner. In general, capital gains from property held by a taxpayer for one year or longer is taxed at the long-term capital gains rate (maximum of 20 percent in 2021), as opposed to the short-term capital gains rate (maximum of 37 percent in 2021).

Section 1061 changes existing law with respect to recipients of profits interests granted in exchange for investment services.

Investment services include raising capital and investing in, disposing of, identifying or developing investment assets such as securities, commodities, or real estate assets.

For such taxpayers, long-term capital gains attributable to their profits interests are determined under general capital gains calculation rules, substituting the extended three-year holding period for the generally applicable one-year holding period. This change will be effective for any sales of profits interests or allocations of income on or after January 1, 2018, and it applies to newly granted profits interests and existing profits interests alike. The extended three-year holding period applies regardless of whether an individual reported income when the profits interest was granted or made an election under Section 83(b) of the Code.

The Act did not grandfather partnership interests issued prior to the enactment of the Act; consequently, partners, partnerships, and limited liability companies should be aware that the provision could affect partnership interests issued in 2015, 2016, and 2017.

On January 7, 2021, the Department of the Treasury and the IRS issued the final regulations implementing Section 1061 (TD 9945) governing the character of carried interest gains allocated to or derived by a service partner in an investment fund. The final regulations clarify certain provisions in the proposed regulations which were published on August 14, 2020 (85 FR 49754).

Section 1061(a) imposes the general three-year holding period requirement for long-term capital gains with respect to carried interest (an "applicable partnership interest" or "API") directly or indirectly transferred to or held by a taxpayer in connection with the performance of services by the taxpayer or any related person in an asset management business (an "applicable trade or business"). Section 1061(c)(4)(B) provides a significant exception in the common situation in which the carried interest holder also owns a capital interest, to the extent of income "commensurate" with the amount of capital contributed by the partner (the "capital interest exception"). The proposed regulations implemented the Capital Interest Exception with fairly restrictive rules which could have prevented a carried interest holder from claiming an exemption on an arm's length return on a contribution of its own capital. The final regulations reflect a more favorable approach.

Section 1061(c)(4)(B) provides that an API does not include certain capital interests. The proposed regulations implement the capital interest exception by excepting from recharacterization long-term capital gains and losses that represent a return on an API holder's capital invested in a passthrough entity (*e.g.*, a partnership,

trust, estate, S corporation, or a passive foreign investment company with respect to which the shareholder has a qualified electing fund election in effect.

The Treasury Department and the IRS said the majority of comments received regarding the capital interest exception suggested that the rules in the proposed regulations were too rigid and did not reflect many common business arrangements, resulting in many capital interest holders being denied eligibility for the exception. The final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed.

The final regulations provide that gain allocated to or derived by a service partner is generally eligible for the capital interest exception if: (a) gain allocated to the service partner on the capital interest is determined in a manner similar to the allocations on capital interests held by unrelated non-service partners that have made significant capital contributions to the fund (the "commensurate with capital requirement"); (2) allocations on the capital interest are clearly identified as separate and apart from allocations on the carried interest in the partnership agreement and in contemporaneous books and records of the partnership (the "clear identification requirement").

If a service partner disposes of a partnership interest, the allocation of gain between its capital interest and its carried interest is made by reference to the gain the partner would have been allocated if the partnership sold the underlying assets for fair market value and distributed the proceeds in liquidation. The rules apply if a service partner sells its capital interest in a fund to another partner or to the partnership, or sells all of its interests in the fund in connection with a sale of the management business, within three years of receipt.

The final regulations treat capital interest allocations as made in a similar manner to those of significant unrelated non-service partners (third-party investors") if they are "reasonably consistent" with the allocations to those third parties, taking into account various economic factors including the amount and timing of capital contributed, the rate of return, the terms, priority, type and level of risk, and rights to cash or property distributions during the partnership's operations and on liquidation. The allocations need not be made based on capital accounts, and can vary by investment or class of interest.

Whether interests held by management are not burdened by management fees or by the carried interest, subordinated to the capital interests of third-party investors, or have enhanced rights to tax distributions in the nature of advances against future distributions, are ignored in determining those interests are capital interests.

The final regulations provide that allocations on a capital interest must be separately identified from allocations on a carried interest in the partnership agreement and books and records created when determining the allocations. The final regulations have no grandfathering rule for existing partnership agreements that do not satisfy these rules.

If a partnership's revaluation of its assets causes a carried interest holder to have a capital account at any tier of the holding structure, the unrealized capital gain or loss attributable to the profits interest for services will retain its character under Section 1061. However, the final regulations confirm that future allocations to the holder attributable to the increase in the capital account will be exempt from Section 1061, provided the allocations otherwise satisfy the capital interest exception, even though the service partner has not paid any tax on the gain.

The final regulations provide that the capital interest exception generally will not apply if the service partner funded its interest with an advance made by the partnership, another partner, or a person related to any of them. Consequently, the capital interest exception will apply only to the extent that the carried interest holder is personally liable for repayment (without guarantee or reimbursement by another party) or actually repays the advance.

The final regulations provide new rules for determining what holding period applies when an asset manager recognizes gain on a disposition of its carried interest. The general rule when applying Section 1061(a) is that the holding period taken into account is the direct owner's holding period in the asset sold, whether that is the manager's holding period in the carried interest or the partnership's holding period in an underlying asset. The final regulations include exceptions that override the application of this rule in certain circumstances, resulting in long-term capital gain being recognized on the disposition of a carried interest as short-term capital gain due to the partnership's holding period in its assets.

Section 1061(d) provides for a look-through when a carried interest is transferred directly or indirectly to related parties, including a family member of the holder or to another service provider in the applicable trade or business. The final regulations define a "transfer" to include any transaction in which gain is recognized, and treat an indirect transfer as occurring to the extent a partnership is owned by related parties. As a result, the look-through rule under Section 1061(d) applies when the general partner of a fund (holding a carried interest) redeems the interest of a withdrawing partner. The final regulations limit the effect of Section 1061(d) to recharacterizing long-term capital

gain otherwise recognized on a related-party transfer, whereas the proposed regulations would have accelerated the recognition of gain realized on related-party transfers in many types of non-recognition transactions.

# Plain, Ordinary Meaning v. Literal Meaning

**BY BARRY SALKIN**

Barry Salkin concentrates his practice in ERISA and employee benefits law. He has significant expertise drafting, amending, and negotiating various ERISA and employee benefit plans, including defined benefit pension plans, profit sharing plans, 401(k) plans, as well as qualified and non-qualified deferred compensation programs. He also has wide-ranging experience crafting group medical and health plans involving Health Care Reform, HIPAA, and COBRA. In addition, he has represented clients in ERISA litigation and audits.

His clients include multi-national corporations, closely-held companies, high-net-worth individuals, financial institutions, governmental agencies, investment groups, and tax-exempt organizations such as hospitals and physicians' organizations.

Barry also advises clients on all aspects of retirement plan tax-qualification requirements and the application of labor and securities laws and regulations to sponsors of employee benefit plans and executive compensation programs. Moreover, he has extensive experience in establishing, merging and terminating benefit plans and compensation agreements, and counsels clients on fiduciary responsibilities and prohibited transactions.

Prior to joining The Wagner Law Group, Barry served as counsel and senior attorney at leading law firms in Manhattan.

The general rule of statutory construction is that statutes should be interpreted to reflect the plain or ordinary meaning[1] of the text. There are, however, two narrow exceptions to the plain meaning doctrine. The first is "the rare case in which the literal application of a statute will produce a result at odds with the intention of its drafters."[2] The second exception is where the plain meaning "results in an outcome that can truly be characterized as absurd,"[3] *i.e.*, that is "so gross as to shock the general moral or common sense." The Supreme Court has indicated that a plain meaning interpretation should not be taken to an absurd result when there is an alternative interpretation more consistent with the legislative[4] purpose.[5]

While there are no obvious instances of an interpretation of an employee benefit section of the Internal Revenue Code of 1986, as amended (the Code) or ERISA that a court treated as absurd, the

exclusive benefit and the anti-alienation provisions of the Code and ERISA illustrate the circumstances in which the plain meaning of a statute will not be followed. Both Circuit Courts of Appeal[6] and the Tax Court[7] have held the exclusive benefit requirement of Code Section 401(a)(2) is not to be interpreted literally. In a pre-REACT general counsel's memorandum,[8] the IRS explained that "in implying exceptions to section 401(a)(13) for alimony, support, and community property cases, the Service[9] and the Courts[10] have considered the policy underlying Section 401(a)(13) and ERISA in general and have determined that family support decrees were not intended to be within the scope of the anti-alienation provisions of ERISA." The Service then addressed a second implied exception to Code Section 401(a)(13). "Likewise, it is our opinion that the application of common law policy by the state through the operation of the state's 'killer statute' pursuant to a Court proceeding was not intended to be within the scope of the anti-alienation provisions of ERISA. Therefore, there is an implied exception to section 401(a)(13) for purposes of applying the common law principle that a killer should not benefit from his or her crime."

The IRS elaborated upon this analysis in a 1989 private letter ruling.[11] in which it sought to reconcile the qualified domestic relations order (QDRO) exception with the exception under Code Section 401(a)(13) for the killer statute. "The policy considerations underlying the anti-alienation provision and its QDRO exception are not inconsistent with the 'killer statute' of State Z. The policy in no way affects the rights of a retired participant to his or her benefits, and only affects the right of a beneficiary to benefits upon the death of the participant if the beneficiary caused that death intentionally and feloniously. In addition, the QDRO exception reflects Congress judgment that the anti-alienation provision will not be used to defeat significant obligations relating to participants family. We believe that Congress would consider a beneficiary's killing of a participant to be sufficiently significant and compelling so as to abrogate his or her rights as a beneficiary who is worthy of concern and to be inconsistent with the policy considerations that underlie the anti-alienation rule."

The canons of construction apply to any legal text and not simply to statutes.[12] Thus, even the literal meaning of a contract must be rejected if it would be clearly unreasonable and yield an unreasonable result."[13] For example, in *Grun v. Pneumo Abex Corp.*,[14] in describing the very limited circumstances in which the Court of Appeals for the Seventh Circuit considers extrinsic evidence when the language of a contract is unambiguous,[15] indicated that its availability when a mutual mistake has occurred in the formation of the contract.

AQ: Please provide the missing opening quotation in the sentence "Thus, even the literal meaning . . .".

However, this consideration of extrinsic evidence was not one to be taken lightly when language is unambiguous, but only in "the rare case where literal application of a text would lead to absurd results or thwart the obvious intention of its drafters."[16]

AQ: Please provide publisher name and location for Eskridge and Frickey (1995) in note 19.

AQ: Is any text missing in the footnote text of note 21.

Although reliance upon dictionaries has been questioned by both courts,[17] lexicographers,[18] and academics,[19] in determining the plain meaning of a term under an ERISA plan, courts frequently turn to dictionaries.[20] However, the plain, ordinary meaning and the literal meaning of a plan or a collective bargaining agreement will not in all circumstances coincide, and as Justice Kavanaugh recently observed in his dissenting opinion in *Bostock v. Clayton County*,[21] "When there is a divide between the ordinary meaning and the literal meaning,[22] courts must follow the ordinary meaning." ERISA cases in a number of areas recognize this principle. As the Court of Appeals for the Sixth Circuit stated in *Citizens Insurance Co. of America v. Michigan Health CorrectCare Network Plan*,[23] "When interpreting ERISA plan provisions, this Court ha[s] often gone beyond the actual language of the plan … to ascertain the underlying intent. In order to determine which [plan] interpretation is correct, [the Court] must consider both the policy language and the intent underlying the provision."[24] While determining when to depart from the literal language of a text may be a difficult inquiry for a court,[25] it has been addressed under ERISA on several occasions.

Perhaps the case that most clearly illustrates the principle[26] is *Helms v. Monsanto Co., Inc*.[27] The issue in that case was the meaning of the phrase, in a disability plan, "from engaging in any occupation or employment for remuneration or profit." As interpreted by defendants, plaintiff would be entitled to benefits under the plan only if he had "no conscious life," a construction which the Court dismissed as rendering the disability plan "totally meaningless." The Court indicated that in interpreting the plan, it must be guided by the general policies underlying ERISA. It explained that the general objective of ERISA is to increase the number of individuals in employer-financed benefit plans. "Congress wanted to assure that those who participate in the plans actually receive the benefits they are entitled to and do not lose these as a result of unduly restrictive provisions." The Court then applied these general principles to the Monsanto plan: "Total disability under this type of provision is not considered to exist if the insured can follow any remunerative occupation, whether in his present vocation or another. The phrase should not be given an absolute and literal interpretation. It should not mean that the affected individual must be utterly helpless to be considered disabled. It must be a relative term which means that the individual is unable

to engage in any remunerative occupation or to do work in some profitable employment or enterprise. …Although the achievements of disabled persons have been remarkable, we will not adopt a strict, literal construction of such a provision which would deny benefits to the disabled if he should engage in some minimal occupation, such as selling pencils or peanuts, which would yield only a pittance. The insured is not to be deemed 'able' merely because it is shown that he could perform some task."[28] Similarly, in *Saffle v. Sierra Pacific Power Company Bargaining Unit long Term Disability Plan,*[29] the Court of Appeals for the Ninth Circuit rejected an interpretation that would deny disability benefits based on language requiring proof of inability to perform "each and every" material duty: "Reading 'each and every' literally could mean either that a claimant is not totally disabled if she can perform any single duty of her job, no matter how trivial—or that a claimant is totally disabled if she cannot perform any single duty, no matter how trivial. There is little question that the phrase should not be given the former construction, as "total disability" would only exist if the person were essentially non-conscious."

In *Allderman v. Central Pension Fund of the International Union of Operating Engineers and Participating Employees*,[30] the District Court rejected defendant's interpretation of its disability plan that only the participant could file a claim for disability benefits: "Literal application would also lead to absurd results. For example, if only the participant could file the application for disability benefits, as defendant argues, the spouse of a participant who is in a coma could not file an application for disability benefits on his behalf, even if the participant otherwise met the definition for total and permanent disability."

In *Burns v. Orthotek, Inc. Employees Pension Plan and Trust,*[31] the plan participant's spouse signed the spousal consent, gave it to her husband, who was the plan administrator, and he knew that it was his wife who gave him the signed form. The question was whether this satisfied the requirement that the consent be witnessed by the plan administrator. The Court of Appeals for the Seventh Circuit held that it did. The Court in *Burns* acknowledged that the common meaning of the word "witness" in the context of legal documents suggests that attestation should be required for a signature to be witnessed. However, "it makes little sense to strictly enforce an attestation requirement if doing so would produce an absurd result"and concluded that on the facts of the case, invalidating the spousal consent would produce an absurd result.

A similar issue was presented in *Vanguard Group, Inc. v. Shikhabolhassani*,[32] the issue was the validity of a spousal consent

witnessed by a notary whose commission had expired. In holding that the spousal consent was nonetheless valid, the District Court acknowledged that the requirement that a consent be notarized logically implies that the notary's commission has not yet expired. However, "on the facts of this case, invalidating Yasamin's consent on that basis" would produce an absurd result. It is undisputed that Yasamin signed the form, and she apparently did so in the presence of someone she thought was a notary for the purpose of verifying the authenticity of her signature." Citing *Butler v. Encyclopedia Britannica, Inc.*,[33] the District Court explained that "Compliance with ERISA's literal language in this case would lead to the absurd result of invalidating a spousal consent form that [Yasamin admits that she signed, but now attempts to disavow on a technicality."[34]

In *Brown v. Blue Cross and Blue Shield of Alabama, Inc.*,[35] the issue was whether a demand for preadmission certification for a second admission under the plan was required, or whether the second admission to the hospital did not require a preadmission certification because it was a continuation of an emergency admission to the hospital for which precertification was not required. In concluding that the action of BlueCross Blue Shield was arbitrary and capricious, the Court held defendants to task for adopting an interpretation of the plan that placed plaintiffs in an untenable position: "Assuming Blue Cross is correct in treating the second appointment as distinct, then the beneficiary must seek preadmission certification. Those procedures, however, do not lend themselves to accomplishment in the few day prior to readmission. Blue Cross, then, must expect the beneficiary to dispute the doctors judgment, following a five-day hospitalization for an emergency, that surgery should take place so soon. Instead, the beneficiary is expected to seek a delay until preadmission certification is obtained. Such a rule seems dangerous if not totally absurd."

In *Wilson v. Group Hospitalization and Medical Services, Inc.*,[36] the issue was interpretation of a policy exclusion for "services or supplies related to transplant procedures." Plaintiff did not seek a transplant as such. However, plaintiff sought high-dose chemotherapy, which would save her life, and for that chemotherapy a bone marrow transplant was a necessary incident. As a result, while chemotherapy and related hospital stays would generally be covered by BlueCross BlueShield, defendants sought to deny coverage because plaintiff's chemotherapy and related hospital stay were "related to" the bone marrow transplant. The District Court rejected defendant's position, which it characterized as too clever by half. It explained that "Eighty to ninety percent of plaintiff's treatment involves chemotherapy. Thus to consider that her primary treatment and every other facet of

her treatment and recovery are removed from coverage through the narrow siphon of the words 'related to' is to contort both the facts and the language. This is illustrated most dramatically by the circumstance that BlueCross refuses to pay even for plaintiff's recuperative stay in the hospital on the basis that it too is 'related to' the transplant—even though the transplant was effected in the past and is not to be repeated. Under these circumstances to say that payment is excluded by virtue of the notion that the entire treatment, in all its facets, past, present, and future is 'related to' bone marrow transplants would truly have the tail wagging the dog."

In *Schneider v. Wisconsin UFCW Union and Employee Health Plan*,[37] the defendants took the position that enteral nutritional therapy (ENT) was not covered because it was simply a substitute for eating for a patient who was unable to swallow because of a malfunction of blood vessels in the brain. Coverage for the treatment was disallowed because it did not "identify or treat" the malfunctioning of blood vessels in the brain. Not surprisingly, the District Court gave short shrift to this line of argument: "The plan's application of the identify and treat requirement is facially unreasonable because it would create a river of absurd results. For example, no surgical anesthesia identifies or treats the problem that required surgery. In fact, while an initial surgical incision is probably a form of treatment, suturing the patient's incision at the end of surgery neither treats or identifies the problem requiring surgery. Of the infinite analogies, the best perhaps is a respirator which does not identify or treat a problem but, in the plan's apparent view, would merely be an alternative means of meeting a person's normal need for oxygen."

In *Tester v. Reliance Standard Life*,[38] under a plan providing coverage for full-time active employees, the insurer denied coverage to an employee who had been absent from the company for a few weeks because of illness. The Court of Appeals for the Fourth Circuit rejected that defense, explaining that "a reasonable employee would not expect his insurance coverage to terminate if he or she takes a sick day or dies on account of an accident before working 20 hours in a particular week. An employee would reasonably expect that his coverage continues while he regularly works for the company, even if he is at home with the flu or injured in a car accident."[39]

In *Watkins v. M Class Mining Health Protection Plan*,[40] the Court rejected defendant's construction that while engaged in an illegal act requires only a temporal connection rather than a causal connection. "The Plan invokes a narrow reading of the term 'while' in order to more broadly exclude coverage for any injuries related to an illegal activity. The Plan's interpretation of the exclusion opens the door to a

denial of coverage of any number of injuries that happen to coincide with any knowing or unknowing violation of any law, including infractions and ordinance violations. … Without a causal connection, the exclusion yields absurd results and renders a meaning contrary to that expected by a reasonable person of average intelligence and experience."[41]

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A series of cases in the Tenth Circuit[42] has rejected the concept of "but for" causation[43] in welfare plans, even though the literal language of the plan or policy could cover "but for" causation. *Kellogg v. Metropolitan Life Insurance Co*.[44] involved an insured who suffered a seizure while driving, causing him to veer off the road and into a tree. He died from injuries sustained in the accident, but the insurer refused to pay benefits, relying on a policy provision that excluded coverage for" any loss caused or contributed to by…physical or mental illness or infirmity." The Tenth Circuit rejected the argument. While Mr. Kellogg would not have been in a fatal accident had he not suffered a seizure, "courts have long rejected attempts to preclude recovery on the basis that the accident would not have occurred but for the insured's illness."[45] A reasonable policyholder, the court concluded, would view the seizure as contributing only to the deceased's car accident, not to his death. Thus, even though the seizure was a but-for cause of Mr. Kellogg's death, the court concluded that the seizure did not "cause" or "contribute" to his death.

Similarly, the policy at issue in *Fought v. Unum Life Ins. Co*[46] excluded coverage for disabilities caused by, contributed, or resulting from a preexisting condition. Ms. Fought had a preexisting coronary artery disease that required surgery. That surgery left a surgical wound that later split open and became infected resulting in Ms. Fought's long-term hospitalization. Unum rejected her claim for benefits on the grounds that her preexisting condition contributed to her disability, or that her disability resulted from her preexisting condition. In rejecting Unum's position, the Court of Appeals indicted that the primary issue was where to draw the line on matters of causation, a mere but-for relationship was insufficient to establish the causal nexus. Accepting Unum's causation argument would "effectively render meaningless the notion of the pre-existing condition by distending the breadth of the exclusion."[47] Kellogg and Fought were followed in *Reiling v. Sun Life Assurance Co. of Canada,*[48] in which the Kansas District Court concluded that while the insured's driving with a suspended license was a but-for cause of her death, in the sense that had she complied with the law she would not have been driving with a suspended license, a criminal act under state law, that was an insufficient causal nexus to deny coverage.[49]

A rule of contract interpretation could also trump what would appear to be the literal language of a plan. In *Smith v. United Television, Inc. Special Severance Plan,*[50] a divided Court of Appeals for the Eighth Circuit held that, although Smith was entitled under the plan to payment if there was a reduction in his salary or bonus opportunity, which would ordinarily be read as disjunctive, when his bonus opportunity more than offset his salary reduction, he was not entitled to payment under the plan.

Creative arguments are not solely the domain of defendants. In *Logan v. Union Security Co*.,[51] plaintiff argued that a suicide exclusion provision in an accidental death and dismemberment plan applied only to accidental dismemberments, an argument which the court technically responded to in dicta, since decapitation was not one of the listed forms of dismemberment under the plan. In *Sisters of The Third Order of St. Francis v. Swedish American Group Health Benefit Trust,*[52] plaintiff argued that an exclusion for expenses incurred while committing an illegal act should be limited to activities such as breaking into a doctor's office at gunpoint and asking him or her to place a splint on an injured finger. The Seventh Circuit found this argument "too clever by half," concluding that this reading of the exclusion clause would drain it of any meaning.

## NOTES

1. While there is some variance in the language employed by Courts, a typical definition would be an objective standard, interpreting the policy language as would a reasonable person of average intelligence and experience. *See Sellers v. Zurich America Insurance Co.*, 627 F. 3d 632 (7th Cir. 2010); *Hodges v. Life Insurance Company of North America*, 92 F. 3d 669 (10th Cir. 2019). *Cf. Vickers v. Boston Mutual Life Insurance Co.*, 135 F. 3d 179 (1st Cir. 1998) ("Why did the Company write a policy that calls for the services of logician rather than relying on "plain meanings…which comport with the interpretation given by the average person?").
2. *United States v. Ron Pair Enterprises*, 489 U.S. 235, 242 (1989).
3. The absurd result exception to the plain meaning rule is narrow and limited to situations "where it is quite impossible that Congress could have intended the result, and where the alleged absurdity is so clear as to be obvious to most anyone." *Gardner v. Derwinski*, 1 Vet. App. 584, 587 (1991), aff'd sub nom *Gardner v. Brown*, 5 F. 3d 1456 (Fed. Cir. 1993), aff'd 513 U.S. 115 (1994). An 1868 Supreme Court illustrates this exception: "It will always…be presumed that the legislature intended exceptions to its language which would avoid unjust, oppressive, or absurd results. …The common sense of man approves the judgment…that the Bolignian law which enacted "that whoever drew blood in the streets should be punished with the utmost severity" does not extend to the surgeon who opened the vein of a person that fell down in the street in a fit." *United States v. Kirby*, 74 U.S. [7 Wall] 482, 486-87 (1868), quoted in John M. Walker, Jr. (2001) Judicial tendencies in statutory construction: differing views of the role of

the judiciary. 58 *NYU Annual Survey of American Law*, *203*, 209–210. A comparable example at common law was the fire at a prison. Although generally escaping from prison was treated as a felony at common law," if the prison be fired, and the prisoner escapes to save his life, this excuses the felony, unless the prisoner himself set fire to the prison. 1 Hale P.C. 611.

4. *Sigmon Coal Co. v. Apfel*, 226 F. 3d 21, 304 (4th Cir. 2000), cited in Chief Counsels Advice, 201555034 (December 11, 2015). *See also*, *Holland v. Big River Minerals Corp.*, 181 F. 3d 597 (4th Cir. 1999); *United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 539 (1939). "Even if the plain meaning did not produce absurd results but merely an unreasonable one plainly at variance with the policy of the legislation as a whole, this Court has followed that purpose rather than the literal words."), cited in Field Service Advice 792 (November 8, 1993).
5. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 575 (1982).
6. *Central Motor Company v. U.S.*, 583 F. 2d 470 (10th Cir. 1978); *Time Oil Company v. Commissioner of Internal Revenue Service*, 258 F. 2d. 237 (9th Cir. 1958).
7. Bing Management, 36 TCM 1633 (1977); *Shedco, Inc., TCM*, 1998-295.
8. GCM 30000, June 16, 1983.
9. Rev. Rul. 80-27, 1980-1 C.B. 85.
10. *See*, for example, *Cartledge v. Miller*, 457 F. Supp. 1146 (S.D.N.Y. 1978) and *Stone v. Stone*, 632 F. 2d 740 (9th Cir. 1980.) *See also, Stobnicki v. Textron*, 868 F 2d 1460 (5th Cir. 1989) ("the apparent statutory bar against alienation of pension benefits must once again yield to reason and the purpose for which the Act was written.").
11. Private letter ruling 9008079 (November 30, 1989).
12. *Smith (William A.) v. Brown*, 35 F. 3d 1516, 1522-24 (Fed. Cir. 1994). *See also*, *Grun v. Pneumo Abex Corp.*, 163 F. 3d 411, 421 (7th Cir. 1998) (a collective bargaining agreement will be interpreted in accordance with its plain meaning, except in "the rare case where literal application of a text would lead to absurd results or thwart the obvious intention of the drafters.").
13. *Koch Business Holdings, LLC v. Amoco Pipeline Holding Co.*, 554 F. 3d 1334, 1338 (11th Cir. 2009). *See also*, *Beanstalk Group, Inc. v. Am. Gen. Corp.*, 283 F. 3d 856, 860 (7th Cir. 2002). ("A contract will not be interpreted literally, if doing so would produce absurd results, in the sense of results that the parties, presumed to be rational persons pursuing rational ends, are very unlikely to have agreed to seek."); *United States v. Irvine*, 756 F. 2d 708, 710-11 (9th Cir. 1985) (A contract should not be interpreted in a way to produce absurd results); *Saint Anthony Medical Center v. Swedish America Group Health Plan*, 901 F. 2d 1369 (7th Cir. 1990) (Courts depart from plain language to avoid absurdity); *Green v. Bock Laundry Machine Co.*, 490 U.S. 504 (1989) (Scalia, concurring); *Church of the Holy Trinity v. United States*, 143 U.S. 457 (1892); *Dispatch Automation, Inc. v. Richards*, 280 F. 3d 1116, 1119 (7th Cir. 2002) ("When a contract interpretation makes no economic sense, that's an admissible and in the limit, a compelling reason for rejecting it.").
14. 163 F. 3d 411 (7th Cir. 1998).
15. *White v. Roughton*, 689 F. 2d. 118 (7th Cir.1982).
16. *Marlowe v. Bottarelli*, 938 F. 2d 807, 812 (7th Cir. 1991).
17. One of the earliest and most frequent critics of the use of dictionaries was Judge Learned Hand, a member of the Court of Appeals for the Second Circuit, who admonished Courts

in *Cabell v. Markham*, 148 F. 2d. 737 (2d Cir. 1945) that: "It is one of the surest indices of a mature and developed jurisprudence not to make a fortress out of the dictionary, but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." He was critical of the "dictionary school" of document interpretation, in which judges "read the words in their usual meaning, and stop where they stop." Learned Hand, "How Far is a Judge Free in Rendering a Decision," (1933), reprinted in The Spirit of Liberty 103, 107, Irving Dillard (2d ed. 1993), quoted in Thomas Merrill (2018), The hands lecture: learned hand on statutory interpretation: theory and practice. 87 *Fordham Law Review* 1.

18. Jesse Seidlower, former editor of the Oxford English Dictionary, commented in 2012 that "It's probably wrong, in almost all situations, to use a dictionary in the courtroom. Dictionary definitions are written with a lot of things in mind, but rigorously circumscribing the exact meanings and connotations of terms is not usually one of them." Quoted in John Calhoun, 124 *Yale Law Journal* 278, "Measuring the Fortress: Explaining Trends in Supreme Court and Circuit Court" (November 2014). Furthermore, reference materials for lexicographers suggest that dictionaries are not definitive accounts of how words always are or should be used. They have also stated that dictionaries provide histories of how people have used words, and are not descriptions of their complete meanings. Ibid.
19. *Calhoun*, *supra*, n. 16. *See also*, Carlton J. Snow (1987). Contract interpretation: the plain meaning in labor arbitration. *Fordham Law Review*, *55*, 68; Philip Rubin (2010). War of the words: how courts can use dictionaries in accordance with textualist principles. *Duke Law Journal, 60*, 167; Rickie Sonpol (2003). Note: old dictionaries and new textualists. *Fordham Law Review*, *71*, 2177; Craig Hoffman (2003). Parse the sentence first: curbing the urge to resort to dictionaries when interpreting legal texts. NYU Legislation and Policy Journal, *6*, 401. A significant portion of the criticism has focused upon the use of dictionary definitions by the Supreme Court. *See*, Ellen Aprill (1998). The law of the word: dictionary shopping in the supreme court. Arizona State Law Journal, *30*, 275, 281; James J. Brudney and Lawrence Baum (2013). Oasis or mirage: the Supreme Court's thirst for dictionaries in the rehnquist and roberts era. *William & Mary Law Review*, *55*, 483, 566;William N. Eskridge, Jr. and Philip P. Frickey (1995). *Cases and Materials on Legislation: Statutes and the Creation of Public Policy* (625-26) (2d Ed. ). Only a few courts have commented upon the criticism of dictionary definitions. *See*, for example, *Bock v. Computer Associates, International*, 257 F. 3d 700(7th Cir. 2001) ("some authorities have questioned the efficacy of recourse in many cases to dictionaries") and *Wilson v. Safelite Group*, 930 F. 3d 429 (6th Cir. 2019). (The par concurrence).
20. The Court of Appeals for the Eighth Circuit has stated on multiple occasions that in determining the plain meaning of words, "Recourse to the ordinary dictionary definitions of words is not only reasonable, but may be necessary." *See*, for example, *Conoco v. Norwest Bank*, 767 F. 2d 470, 471 (8th Cir. 1985); *Central States Southeast and Southwest Pension Fund v. Rubin*, 919 F. 2d 1343 (8th Cir. 1990); *Khoury v. Group Health Plan, Inc*.,615 F. 3d 946, 955 (8th Cir. 2010); *Rathman v. Union Security Insurance Co*.,2018 WL 4353689 (D. Minn., September 12, 2018) (When a plan does not define a given term, parties may consider the term's "ordinary, plain" meaning, consulting the "ordinary, dictionary definition of that term as necessary," citing *Spizman v. BlueCross Blue Shield of Minnesota, Inc*., 855 F. 3d 924, 927

(8th Cir. 2017). *See also*, *United States v. Lachman,* 387 F. 3d 42, 51(1st Cir. 2004) ("Dictionaries of the English language are a fundamental tool in ascertaining…plain meaning."); *Levinsky's Inc. v. Walmart Stores*, 127 F. 3d 122, 129 (1st Cir. 1997) ("We start, as we often do in searching out the meaning of a word, with the dictionary."); In re: *Mallo*, 774 F. 3d 1313, 1321 (10th Cir. 2014) ("Dictionary definitions are "useful touchstones" to determine an undefined term's ordinary and common meaning"); *Fralich v. Plumbers and Pipefitters National Pension Fund*, 2010 WL2563429 (N.D. Tex. June 28, 2010), aff'd 420 Fed. Appx 364 (5th Cir. 2011, 1999), citing *Branson v. Greyhound Lines, Inc. Amalgamated Council Retirement and Disability Plan*, 126 F. 3d 747, 758 (5th Cir. 1997); *Myers v. Texas Health Resources*, 2011 WL 1238923 (N.D. Tex. April 4, 2011 (same); *Niedermaier v. Southern Tier Building Trades Benefit Plan*, 62 F. Supp. 3d 275 (W.D.N.Y. 2014) ("It is appropriate to rely upon dictionary definitions when interpreting the terms of an ERISA plan"); *Smith v. United Television, Inc. Special Severance Plan*, 474 F. 3d 1033 (8th Cir. 2007) ("We may turn to dictionary definition of a plan term when the plan is silent on its definition"); *Cash v. Walmart Group Health Plan*, 107 F. 3d 637, 643-44 (8th Cir. 1997); *Littlefield v. Acadia Ins. Co.*, 392 F. 3d 1, 8 (1st Cir. 2004) ("Courts may refer to dictionaries to help elucidate the common understanding of terms, although the dictionary definition is not controlling."); *Martinez v. Sun Life Assurance Co. of Canada*, 948 F. 3d 62 (1st Cir. 2020) *Langley v. Howard Hughes Management Co., LLC*, 2017 WL 2390609 (5th Cir. June 1, 2017) ("dictionary definitions are helpful in reading an ERISA plan"); *Gross v. St. Agnes Health Care, Inc.*, 2013 WL 4925374 (D. Md. Sept. 12, 2013) ("If common sense and logic are not enough, I note that, to ascertain the plain meaning of contractual terms, courts often look to dictionaries.") Cf. *Korach v. Zurich Amer. Ins. Co.*, 587 F. 3d 323, 333 (6th Cir. 2009) (applying the dictionary definition of accidental to determine the ordinary meaning) *Chacko v. Sabre, Inc.*, 473 F 3d 604 (5th Cir. 2006) (consulting dictionary definition when interpreting plan terms); *Iron v. Prudential Insurance Co. of America*, 964 F. 2d 463, 464-65 (5th Cir. 1992) (relying on dictionary definition of limb in interpreting a plan provision providing coverage for "artificial limbs, larynxes, and eyes."); *United States v. Floyd*, 81 F. 3d 1517, 153 (10th Cir. 1999) (applying ordinary meaning found in dictionary when Congress does not define the term). Where a term is defined by a statute or by a contract, reliance upon a dictionary definition is inappropriate. *Hatahley v. United States*, 351 U.S. 173, 179 (1956); *Jensen v. Solvey Chemicals, Inc.*, 788 F. Supp. 2d 1278, n. 1 (D. Wyo. 2011); *Beverage Industry Local No. 744 v. Quality Beer Limited Partnership*, 1999 WL 571007 (N.D. Ill. July 28, 1999). Additionally, "the relative order of the common dictionary definitions of a single term does little to clarify that term's meaning within a particular context when a word has multiple definitions, usage determines its meaning." *Trustees of the Chicago Truck Drivers, Helpers and Warehouse Workers Union (Independent) Pension Fund v. Leaseway Transportation Corp.*, 76 F. 3d 824, fn. 4 (7th Cir. 1996).

21. 590 U.S. ____ (2020).
22. Consistent with his concerns about the use of dictionaries, Judge Hand also cautioned that "there is no surer way to misread any document than to read it literally." *Guiseppi v. Walling*, 144 F. 2d 608,624 (2d Cir.1944). *See also*, *Peter Pan Fabrics, Inc. v. Martin Weiner, Corp*.. 27 F. 2d 487, 489 (2d Cir. 1960) ("It is a commonplace that the literal interpretation of the words of a statute is not always a safe guide to its meaning."); *New York Trust Co. v. Commissioner*

*of Internal Revenue*, 68 F. 2d 19, 20 (2d Cir. 1933) ("a sterile literalism which loses sight of the forest for the trees") and *Federal Deposit Insurance Corp v. Tremaine*, 133 F. 2d. 827, 830 (2d Cir. 1945). To be clear, this article takes no position om Judge Hand's views on statutory construction, which are far more nuanced than illustrated by the quotations I have cited. However, quotations of this nature will be useful to counsel challenging a literal construction of a plan provision.

23. 449 F. 3d 688 (6th Cir. 2006).
24. *See also*, *Regents of the University of Michigan v. Employees of Agency Rent a Car Hospital*, 122 F. 3d 336 (6th Cir. 1997) ("A technical construction of a policy's language which would defeat a reasonable expectation of coverage is not favored.").
25. *See*, *United States v. Klinger*, 199 F. 2d 645, 648 (2d Cir. 1952) ("The issue involves the baffling question which comes up so often in all kinds of writings: how far is it proper to read the words out of their literal meaning in order to realize their overriding purpose.").
26. This article is not intended to provide an exhaustive list of cases in which courts did not interpret a plan provision in its literal sense, but rather to indicate representative cases.
27. 728 F. 2d 1416 (11th Cir. 1984).
28. *Helms v. Monsanto* has been followed in *Madden v. ITT Long Term Disability Plan*, 914 F. 2d 1279, 1285 (9th Cir. 1990); *Torix v. Ball Corp*.,862 F. 2d 1428, 1431 (10th Cir. 1988) ("We believe that the policy concerns which underlie ERISA would be severely undermined if we endorsed a literal reading of the plan's terms."); *Brasher v. Prudential Insurance Company of America*, 771 F. Supp. 280 (W.D. Ark. 1991); *Demirovic v. Bldg. Serv*. *32 B-J Pension Fund*, 467 F. 3d 208 (2d Cir. 2006); *Vanderkirk v Provident Life and Accident Ins. Co*., 956 F. 2d 610, 614-15 (6th Cir. 1992); *Doyle v. Paul Revere Life Ins. Co.,* 144 F. 3d 181, 184 (1st Cir. 1998); *Tracey v. Pharmacia & Upjohn Absence Payment Plan*, 195 Fed Appx. 511 (6th Cir. 2006); *Hammond v. Fidelity & Guaranty Life Insurance Co*., 965 F. 2d 428 (7th Cir. 1992); *Solnin v. GE Group Life Assurance Co*., 2007 WL 923083 (E.D.N.Y March 23, 2007); *Townsend v. Delta Family Care Disability and Survivorship Plan*, 295 Fed. Appx. 971 (11th Cir. 2008). *Cf. Criss v. Union Security Ins. Co*., 2014 WL 2707774 (N.D. Ala. June 11, 2014) ("A disability claimant does not have to be a blind paraplegic in order to be 'disabled' within the meaning of that word in a benefits plan.").
29. 85 F. 3d. 455 (9th Cir. 1995).
30. 2016 WL 183552 (N.D. Ind. January 14, 2016).
31. 657 F. 3d 571 (7th Cir. 2011).
32. 2014 WL 6694802 (S.D. Tex. November 26, 2014).
33. 41 F. 3d 285 (7th Cir. 1994).
34. Id. at 294, cited in Vanguard, n.29, *supra*, at *5.
35. 898 F. 2d 1556 (11th Cir. 1990).
36. 791 F. Supp. 309 (D.D.C. 1992).
37. 1997 WL 755403 (E.D. Wisc. Dec. 4, 1997).
38. 228 F. 3d 372 (4th Cir. 2000).
39. *See also*, *Carlile v. Reliance Standard Ins. Co*., 385 F. Supp. 3d 1180 (D. Utah 2019) (although plaintiff generally must establish entitlement to benefits, it was unreasonable to require an exempt employee whose hours were not tracked to prove he worked at least 30 hours per week).
40. 2020 Ill. App. (5th Dis.) 18103 (May 7, 2020).

41. *See also*, *Bekos v. Providence Health Plan*, 334 F. Supp. 2d 1248 (D. Or. 2004) (If interpreted without regard to its context, the "other illegal act" phrase could exclude coverage for beneficiaries who "(1) trip on a sidewalk while jaywalking; (2) have their cars hit by a semi-truck while driving one mile per hour over the posted speed limit or (3) not wearing a seat belt when hit by another vehicle while executing a turn without displaying a turn signal; (4) fall off a ladder while remodeling a house without all relevant government permits; (5) are bitten by their dog when they have not yet obtained a dog license; or (6) fall into a fire while burning yard debris with no burn permit").
42. This line of analysis is not restricted to the Tenth Circuit. *See*, for example, *Vickers v. Boston Mutual Life Ins. Co*., 135 F.3d. 179 (1st Cir. 1998) (heart attack caused the crash, but the crash caused the insured's death); *Hastie v. J.C Penney Life Insurance Co*., 115 F. 3d 895 (11th Cir. 1997); *Ciberray v. L-3 Communications Corporation, Master Life and Accidental Death and Dismemberment Plan*, 2013 WL 2481539 (S.D. Cal. June 10, 2013); *Giangreco v. United States Life Ins Co*., 168 F. Supp. 2d 417 (E.D. Pa. 2001).
43. *See*, Couch on Insurance Section 140.8 (Illegal act exclusion generally will not apply, when the illegal act simply affords the occasion of the injury, as there "must be a slight causative connection between the violation and the existing loss.").
44. 549 F. 3d 818 (10th Cir. 2008).
45. Id. at 831.
46. 379 F. 3d 997 (10th Cir. 2004), abrogated on other grounds by *Metropolitan Life Ins. Co. v. Glenn*, 554 U.S. 105 (2008).
47. Id. at 1009–1010.
48. 2014 WL 6895951 (D. Kan. Dec. 5, 2014).
49. *See also*, *LaAsmar v. Phelps Dodge Corp*., 605 F. 3d 789 (10th Cir. 2010) (driving under the influence of alcohol did not "cause" his death in a single vehicle accident); *Johnson v. Life Investors*, 98 Fed. Appx. 814 (10th Cir. 2004) (applying Utah law); *Kassa v. The Plan Administration Group of Citigroup, Inc*., 2011 WL 2731208 (D.N.M. June 30, 2011).
50. 474 F. 3d 1033 (8th Cir. 2007).
51. 2015 WL 3745047(C.D. Cal. March 31, 2015).
52. 901 F. 2d 1369 (7th Cir. 1990).