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THE SUPREME COURT'S MISLEADING FOOTNOTE IN GENERAL DYNAMICS

by Erik M. Jensen

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In this article, Jensen closely inspects footnote 3 in the Supreme Court's opinion in United States v. General Dynamics. In that case, governed by the law as it existed before the TRA of 1984, the Court denied General Dynamics a deduction attributable to claims for employee medical expenses until the claims were approved. In the footnote, the Court suggested that the 1984 amendments to section 461(h) of the Code postponing the time for deducting accrued expenses until economic performance would, in a similar case today, defer General Dynamics' deduction still further, until time of payment. Jensen argues that the Court was wrong as a general matter even though its suggestion may accidentally lead to the right timing result in some cases. He argues that the Supreme Court misread the legislative history of section 461(h) and provided no theoretical reason for treating economic performance as occurring at the time of payment (rather than the time services are provided) in the case of "employee benefit liabilities." Moreover, the Court ignored the potential effects of other sections of the Code, such as section 404, which may control the timing of deductions associated with deferred benefits provided through unfunded medical reimbursement plans.

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Within the past three years, the Supreme Court has decided two cases dealing with the timing of deductions by accrual-basis taxpayers. *United States v. Hughes Properties, Inc.*,[1] involving a casino's deduction of the net increase in its progressive jackpot obligations for the year, and *United States v. General Dynamics Corp.*,[2] concerning a medical self-insurer's deduction of additions to its reserve for "incurred but not reported" claims, have many failings, including misapplication of the "all events" test and internal inconsistency.[3] This article examines one specific failing: in footnote 3 of its opinion in *General Dynamics*, the Supreme Court misstated changes made by the Tax Reform Act of 1984 in a way that may lead the unwary reader into major planning mistakes.

The Court...provided a very misleading impression of the analysis necessary after the Tax Reform Acts of 1984 and 1986....

Although decided in 1986 and 1987, the cases were governed by the law as it existed prior to the Tax Reform Act of 1984.[4] That the Court spent its time on these controversies is curious in itself. The 1984 Act made changes, particularly in adding the "economic performance" requirement of Code section 461(h), that will affect the analysis, if not always the result, in similar cases in the future.[5] Whatever the merits of granting the petitions for *certiorari*, however, the Court had no reason to invoke the new statute in its opinions. In footnote 3 of *General Dynamics*, the Court did so anyway. It provided a very misleading impression of the analysis necessary after the Tax Reform Acts of 1984 and 1986 to determine

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[1]476 U.S. 593 (1986).
[2]107 S. Ct. 1732 (1987).
[3]The author has examined the cases at length in Jensen, "The Supreme Court and the Timing of Deductions for Accrual-Basis Taxpayers," 22 *Georgia Law Review 229 (1988).*
[4]The changes affecting timing made by the Tax Reform Act of 1984 are generally effective for deductions that, under prior law, would have been allowable after July 18, 1984. Pub. L. No. 98-369, section 91(g)(1), 98 Stat. 494, 608.
[5]For some ruminations about why the Court might have granted *certiorari* in the wake of the statutory changes, see Jensen, "*Hughes Properties* and *General Dynamics*: The Supreme Court, The All Events Test, and the 1984 Tax Act," 32 *Tax Notes* 911-12 (1986).

the timing of deductions associated with "employee benefit liabilities."

This article explains why footnote 3 is at best misleading and at worst dead wrong. The article first discusses the applicable law prior to the 1984 Act and describes how the Supreme Court applied that law in *General Dynamics*. Part II describes in general the effect of the 1984 Act on the analysis of the deductibility of future obligations. Part III analyzes footnote 3 of *General Dynamics* in light of the theory and legislative history of the 1984 Act. Finally, Part IV suggests the proper analysis required under present law to determine the timing of deductions associated with an unfunded medical reimbursement plan like that in *General Dynamics*.

I. Pre-1984 Act Law

Prior to the Tax Reform Act of 1984, an accrual-basis taxpayer was in general required to satisfy the two prongs of the regulatory "all events" test in order to deduct an otherwise accruable liability in the current taxable year.[6] The taxpayer had to demonstrate that "all the events have occurred which determine the *fact* of the liability" and that "the *amount* thereof can be demonstrated with reasonable accuracy."[7] As *Hughes Properties* and *General Dynamics* reached the Supreme Court, both cases implicated only the first prong of the test, the fact of liability.[8] To meet that requirement, a taxpayer had to prove the absence of contingencies (other than the obligor's ability to pay) that could defeat the obligation.[9]

The Commissioner...maintained that the fact of liability could be established only upon approval of a claim.

The fact of liability issue in *General Dynamics* was a common one. Under collective bargaining agreements, General Dynamics Corp. was required to provide health insurance coverage for its employees, and in 1972 it became a self-insurer. It established reserves to meet its estimated liability and retained the two insurance firms that had earlier provided coverage to evaluate and approve benefit claims. On its tax return for 1972, General Dynamics deducted its liability, as an ordinary and necessary business expense, for medical services assumed to have been performed during the year.[10] It deducted not only its liability for those employees whose claims had been approved during the year, but also its estimated liability for claims during the year that either had not yet been filed, or, if filed, had not yet been approved.[11]

The Commissioner challenged the deductions attributable to those claims that had not been approved by the end of 1972. He maintained that the fact of liability could be established only upon approval of a claim. Until that time, no one could be certain that an affected employee would file a claim or, if a claim was filed, that the plan administrator would approve reimbursement.[12]

General Dynamics prevailed in the lower courts,[13] but the Supreme Court largely accepted the Commissioner's position. The Court concluded that the *filing* of a claim by an employee is necessary to fix the fact of liability, and thus General Dynamics had improperly taken deductions in 1972 with respect to any medical services for which claims had not been filed by the end of that year. In addition, General Dynamics lost its 1972 deduction for claims that had been filed but had not yet been approved by the end of the year; the company had not created a record at trial to establish those potentially deductible amounts.[14]

Based on the law prior to the 1984 Act, including the Supreme Court's decision in *General Dynamics*, one can posit five stages in the lifespan of employees' claims under an employer's self-insurance plan. For estimates associated with medical services not yet performed and

[6]This article considers only timing issues—that is, the proper taxable year for a deduction to be taken. It is assumed that statutory authority (such as IRC sec. 162) exists for any deduction.

[7]Reg. section 1.461-1(a)(2) (emphasis added).

[8]In *Hughes Properties*, the government had conceded at the outset the reasonable accuracy of the amount claimed as a deduction. 476 U.S. at 597. In *General Dynamics*, while disagreeing with the lower courts' resolution of the amount of liability issue, the government limited its petition for *certiorari* to the fact of liability. See 107 S. Ct. at 1735 n.2.

[9]See, e.g., *Brown v. Helvering*, 291 U.S. 193 (1934). Although the taxpayer must generally show the absence of contingencies, the test is not read literally to require absolute certainty. Contingencies of some sort always exist until the obligation is actually fulfilled (such as by payment). The cases have phrased the issue in terms of the absence of contingencies, but the underlying question appears to be "How contingent is too contingent?" See Jensen, "The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, the All Events Test, and Economic Performance," 37 *University of Florida Law Review* 443, 455-56 (1985).

[10]*General Dynamics*, 107 S. Ct. at 1734-35. As a "self-insurer," General Dynamics took over the obligation to reimburse employees for medical expenses covered under its plans; the company was therefore providing insurance for its employees. General Dynamics followed actuarial principles in determining the amount of its deduction, but it did not claim to be an "insurance company" entitled for that reason to deduct additions to reserves. See IRC sec. 807 (permitting deduction for additions to reserves by life insurance companies); IRC sec. 832(b)(5) (permitting deduction for additions to reserves by non-life insurance companies). Cf. Brooke, Dirig & Yuhas, "Taxation of HMOs After Section 461(h) and *General Dynamics*," 68 *Journal of Taxation* 358 (1988) (suggesting that health maintenance organizations try to qualify as insurance companies in order to deduct current additions to reserves for incurred but not reported claims). In fact, from General Dynamics' perspective, although the new arrangement was called "self-insurance," it was technically not insurance at all. General Dynamics was shifting none of its own risk to another, unrelated party. See Barker, "Federal Income Taxation and Captive Insurance," 6 *Virginia Tax Review* 267, 280 (1986).

[11]*General Dynamics*, 107 S. Ct. at 1734-35. On its original return, General Dynamics deducted no part of the self-insurance reserves. However, upon commencement of an Internal Revenue Service audit, the company filed an amended return claiming entitlement to a deduction for the additions to the reserves. *Id.* at 1735.

[12]See Petition for Writ of Certiorari at 8, *General Dynamics* (No. 85-1385).

[13]*General Dynamics Corp. v. United States*, 6 Cl. Ct. 250 (1984), *aff'd*, 773 F.2d 1224 (Fed. Cir. 1985).

[14]*General Dynamics*, 107 S. Ct. at 1737. The Court noted the general proposition that the taxpayer must show its entitlement to a deduction, citing *Helvering v. Taylor*, 293 U.S. 507, 514 (1935). *General Dynamics*, 107 S. Ct. at 1737.

claims therefore not yet filed, General Dynamics took no deductions, consistent with the common understanding of the all events test. With respect to medical services performed but claims not filed, General Dynamics had taken deductions—unsuccessfully, as it turned out, under the Supreme Court's decision. For additions to reserves associated with claims filed but not yet approved, the government had argued that no deduction was permissible, but the company apparently would have prevailed if it had proven the amount attributable to such claims. For approved but unpaid claims, there was no dispute about deductibility. Finally, *a fortiori*, paid (and previously undeducted) claims were currently deductible.

II. TRA of 1984

In the 1984 Act, Congress significantly changed the rules governing the timing of deductions by accrual-basis taxpayers. While retaining the all events test, and elevating it from the regulations to the Code,[15] section 461(h) requires that a deduction generally be taken no earlier than "economic performance."[16] As a result, to be entitled in the current taxable year to deduct an obligation payable in the future, a taxpayer must now demonstrate not only the fact and the amount of the liability, the two traditional components of the all events test, but also the occurrence of economic performance.

The nature of the transaction determines the time when economic performance is deemed to occur. For example, economic performance attributable to an obligation to provide or pay for property or services occurs only as the property or services are provided.[17] Economic performance with respect to a liability arising either under a worker's compensation statute or out of a tort occurs only as payment is made to another person.[18] The Secretary of the Treasury is given authority to provide exceptions to these rules[19] and also to define economic performance for cases not specifically covered by the statute.[20]

Section 461(h) generally operates to defer deductions beyond the time that they could have been taken under pre-1984 Act law.[21] Indeed, the section was added to the Code because of the congressional perception that, under the historical all events test, accrual-basis taxpayers had been able to generate deductions that exceeded the true cost of the liabilities to which the deductions related—so-called "premature accruals."[22]

Consider a taxpayer that has a present, fixed liability to pay $100 in five years for an otherwise deductible expense. Assume that both prongs of the all events test have been satisfied. If no other statutory barrier intervened, the taxpayer could deduct the entire $100 currently, without any discounting to reflect the time value of money. However, a current deduction equals the cost of the liability only if the taxpayer is limited to the present value of the future obligation,[23] and no Code provision or judicial decision has limited a taxpayer to a discounted deduction in such circumstances.[24]

The taxpayer could deduct the entire [amount] . . . without any discounting to reflect the time value of money.

Under section 461(h), if the future liability is associated with the provision of property or services, and if the property or services are provided in year five, the $100 will not be deductible until that time. The deduction and the true cost of the obligation will, in this example, be perfectly meshed at the later date: "Economically, a present deduction of the present value [of an obligation payable in the future] is equivalent to a future deduction

[15]IRC sec. 461(h)(4) follows the language of the regulations: "the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy."

[16]IRC sec. 461(h)(1).

[17]IRC secs. 461(h)(2)(A), 461(h)(2)(B).

[18]IRC sec. 461(h)(2)(C).

[19]IRC sec. 461(h)(2) (introductory language states "[e]xcept as provided in regulations prescribed by the Secretary").

[20]IRC sec. 461(h)(2)(D).

[21]See Bowers & Stone, "Some Items Still Deductible Under All-Events Test Despite New Economic Performance Rules," 64 *Journal of Taxation* 354, 354 (1986). Because it adds a requirement to the all events test, section 461(h) of course cannot result in deductions earlier than permitted under pre-1984 Act law. If the all events test and the economic performance requirement are satisfied simultaneously, the time of deduction is the same whether pre- or post-1984 Act law governs.

[22]See H.R. Rept. No. 432, 98th Cong., 2d Sess. 1254 (1984) [the 1984 House Report]; Staff of Senate Finance Committee, 98th Cong., 2d Sess., Deficit Reduction Tax Bill of 1984 Explanation of Provisions Approved by the Committee on March 21, 1984, at 271 (1984) [the 1984 Senate Report]; Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 260 (Comm. Print 1984) [the 1984 Blue Book].

[23]The present value of that future obligation, using a discount rate of five percent compounded semiannually, is $78.12. That is, if the taxpayer invested $78.12 today at a five percent after-tax rate of return, it would have the $100 in five years necessary to satisfy the liability. Other authors have posited extreme cases that produce "cost-free" liabilities, where the tax savings from the accelerated deduction equals or exceeds the true cost of the liability. See, e.g., McGown, "Structured Settlements: Deduct Now and Pay Later," 60 TAXES—*The Tax Magazine* 251, 251-53 (1982).

[24]See *Burnham Corp. v. Commissioner*, 90 T.C. No. 62 (1988) (noting lack of authority); Sheppard, "Economic Nonperformance: Doing Without Section 461(h) Regulations," 40 *Tax Notes* 337, 338-39 (1988) (discussing *Burnham Corp.*). Commentators have suggested the appropriateness of such discounting for accrual-basis taxpayers. See, e.g., Aidinoff & Lopata, "Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future," 33 *Tax Lawyer* 789, 811-23 (1980).

Discounting of present deductions (rather than deferral of undiscounted deductions) is required only in certain very specialized areas. For example, the Tax Reform Act of 1986 requires that the deduction available to non-life insurance companies for "unpaid losses" be discounted to present value. See IRC sec. 832(b)(5), *as amended by* Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1022(a), 100 Stat. 2085, 2397-99; IRC sec. 1023(c), 100 Stat. 2085, 2399-2404.

of the future value."[25] The statute is not perfect—in some circumstances it still permits a taxpayer who is obligated to make a future payment to take an undiscounted deduction in a year before the payment is made[26]—but it is a decided improvement over pre-1984 Act law.

Section 461(h) is undoubtedly an impediment [to]...the tax planner, who generally wants to accelerate deductions....

From the standpoint of the tax planner, who generally wants to accelerate deductions, section 461(h) is undoubtedly an impediment. In addition, because its application in many cases may be inconsistent with generally accepted accounting principles, the economic performance standard increases bookkeeping requirements. Recognizing this fact, Congress provided a potentially important exception to the economic performance requirement for "certain recurring items." A liability is considered as incurred within a taxable year, even though economic performance has not occurred in that year, if four conditions are met:

1. The all events test, applied without an economic performance requirement, is satisfied;
2. Economic performance in fact occurs within a reasonable period after the close of the taxable year (and in no event any later than 8½ months after such close);
3. The item is recurring and the taxpayer's treatment is consistent from year to year; and
4. Either the item is not a material item or accrual in the taxable year results in a "more proper" matching of expenses and income than would accrual in a later year.[27]

The relief provided by the "recurring items" exception is more apparent than real, however. The exception contains many ambiguities, and, as critics have noted, "[I]n many if not most of the cases, it will be difficult to determine if the exception is available."[28] The materiality-matching alternative in the fourth requirement is hardly self-defining in its application. And how should the second requirement, the 8½ month test, be applied to a set of facts where there is generally, but not always, performance within the short period? In a case like *General Dynamics*, for example, should compliance with the test be measured on an aggregate basis or by use of a claim-by-claim analysis?[29]

III. Footnote 3

The economic performance requirement did not apply in either *Hughes Properties* or *General Dynamics*.[30] At the time the Court was considering *Hughes Properties*, decided in June 1986, the Justices may not even have been aware that the statutory changes could affect the analysis of similar cases in the future.[31]

By the time of its decision in *General Dynamics* less than 11 months later, the Court had become aware that the statute had changed and that future cases would not be analyzed under the principles of *General Dynamics* alone. Indeed, in footnote 3, the Court not only let us know that it had become informed that recent legislative developments had occurred,[32] it also hinted at the effect of those changes:

> We do not address how this case would be decided under section 461(h), but note that the legislative history of the Act indicates that, "[i]n the case of...employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made."[33]

The Court...did precisely what it purported not to do: to suggest the resolution...under the new statute.

Thus, the Court in one sentence did precisely what it purported not to do: to suggest the resolution of a similar case under the new statute.

Some readers of the opinion immediately took the footnote at face value, as if it resolved any ambiguity that might otherwise have existed.[34] Tax planners should not rely on the Supreme Court for tax research, however. The Court's gratuitous suggestion does not stand up to scrutiny. It has no theoretical basis, and it is an embarrassing misreading of legislative history.

Consider two economically similar cases. If Able performs services for Baker, economic performance is deemed to occur with the performance of those services. Thus, if the all events test is otherwise met by that time, Baker is then entitled to a deduction. If, however, Able performs services for an employee of Baker, and Baker is

[25]Bradley & Winslow, "Self-Insurance Plans and Captive Insurance Companies—A Perspective on Recent Tax Developments," 4 *American Journal of Tax Policy* 217, 233 (1985) (footnote omitted); see Gunn, "Matching of Costs and Revenues as a Goal of Tax Accounting," 4 *Virginia Tax Review* 1, 31 n.144 (1984).

[26]If the taxpayer in the example receives services (and therefore economic performance occurs) in year five but pays the $100 for the services in year six, the taxpayer may still receive the economic benefit of a deduction that is one year premature under the new statute. The present value in year five of the obligation to pay $100 in year six is $95.18, using a discount rate of five percent compounded semiannually. Cf. note 23, *supra*. However, if IRC sec. 461(h) is applicable, and no other timing rule (such as IRC sec. 83(h) or IRC sec. 404(a)(5)) overrides the effect of that section, nothing precludes the taxpayer's taking a deduction for the full $100 in year five.

[27]IRC sec. 461(h)(3)(A).

[28]Bowers & Stone, *supra* note 21, at 356.

[29]See notes 75-80, *infra*, and accompanying text (discussing similar issue under IRC sec. 404).

[30]See note 4, *supra* (effective date of changes made by 1984 Act); see also *General Dynamics*, 107 S. Ct. at 1735-36 n.3.

[31]See Jensen, *supra* note 5, at 911-12.

[32]I suspect that is one of the reasons for the footnote.

[33]107 S. Ct. at 1736 n.3 (quoting 1984 House Report at 1255, and citing H.R. Rept. No. 861, 98th Cong., 2d Sess. 872 (1984) (conference committee explanation of House bill) [the 1984 Conference Report].

[34]Among the misled were the preparers of the *Newsletter* of the American Bar Association's Section of Taxation. See 6 *Section of Taxation Newsletter* 62-63 (1987).

obligated to pay for the services, the Court suggests that economic performance occurs only when payment is made. From the standpoint of Baker, the party for whom services are being performed directly or indirectly, is there any principle that justifies a different result in the timing of deductions?

Delay of the deduction until payment is consistent with the theory that should have governed section 461(h); such a rule would eliminate premature accruals.[35] That theory, however, is not uniformly reflected in the definitions of economic performance. The statute by its terms permits the deduction of many liabilities before payment occurs,[36] and there is nothing obviously peculiar about services provided in connection with "employee benefit liabilities" that justifies treatment different from the provision of services generally.[37]

In addition, the language of section 461(h) contains no suggestion that medical self-insurance plans should be governed by any principle other than that applicable to "services...provided to the taxpayer"; that is, economic performance occurs as services are performed.[38] The government could argue that the medical services (assuming those are the critical services for analytical purposes[39]) are not being provided to the "taxpayer," a self-insured employer like General Dynamics, but such an argument is formalistic at best. If the services are provided at a taxpayer's expense pursuant to a contract between the taxpayer and its employees, they are being provided for the indirect benefit of the taxpayer-employer.

The language that the Court quoted...applied to a version of the 1984 legislation that was not enacted.

This leaves no theoretical basis for distinguishing the two hypothetical cases involving services, and the Court's suggestion about the effect of section 461(h) is therefore suspect. It is perhaps unfair to chastise the Court for not providing a justification grounded in theory on an issue that the Court purported not to have addressed. But the failure on this point goes beyond lack of theoretical sophistication. The language that the Court quoted from the legislative history applied to a version of the 1984 legislation that was not enacted. Any lawyer who deals with statutes knows that one must examine interpretive passages in a congressional committee report in light of the language that the report is interpreting; we should expect no less from the Justices and clerks of the United States Supreme Court.

The full language of the committee report, without the Court's artful ellipsis, provides that, "[i]n the case of worker's compensation, tort, and employee benefit liabilities, which require a payment by the taxpayer to another person, economic performance occurs as the payments to such person are made."[40] That passage interprets language in the House bill that said precisely the same thing—language applying to the three named categories of liabilities.[41] But that language did not survive the legislative process intact. At some point in the House-Senate conference committee deliberations, the bill's reference to "employee benefit liabilities" was deleted.[42] The Code section as enacted treats "payment" as the event of economic performance only for worker's compensation and tort liabilities.[43] If "payment" is to constitute

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[35]See note 26, *supra*, and accompanying text.

[36]See notes 17-20, *supra*, and accompanying text. Under the statute, economic performance is defined as occurring on payment only with respect to worker's compensation and tort liabilities. IRC sec. 461(h)(2)(C).

[37]If there are hidden peculiarities that should have controlling effect, the Court did not enlighten us about them. Two possibilities come to mind, but neither persuasively requires reading a payment requirement into the statute.

First, in the employee reimbursement situation, it is unclear from the statutory language whose services are relevant—that is, whether the analytical focus should be on the medical services or on the employee's services to the employer. See W. Klein, B. Bittker & L. Stone, *Federal Income Taxation* 437 (7th ed. 1987) (assuming performance of medical services is controlling). But see note 46, *infra*, and accompanying text (1984 Conference Report suggesting economic performance occurs as the employee performs services). Whatever uncertainty may exist on this point, however, it provides no reason to delay the deduction until a still later time, the time of payment. Moreover, the uncertainty will have little practical effect because the two types of services are in nearly all cases provided simultaneously. The medical services are provided to an employee (or family member of an employee) during that person's employment.

Second, in some employer-employee cases, concern may arise that the employer's deduction precedes inclusion of income by the employee. Several Code provisions seek to ensure "inter-taxpayer matching," deferring a deduction until a corresponding inclusion occurs. See, e.g., IRC sec. 83(h) (deferring deduction attributable to compensation-related transfer of property until amount is included in gross income of service-provider). With a plan like that in *General Dynamics*, however, inter-taxpayer matching cannot be effected if the employer is to be entitled to a deduction: the reimbursement of the medical expenses is generally excludable from the gross income of the employees. See IRC sec. 105(b). But see IRC sec. 89 (new provision denying exclusion of benefits to highly compensated employees if benefit plan is discriminatory).

[38]IRC sec. 461(h)(2)(A) provides:

> If the liability of the taxpayer arises out of—
> (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
> (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or
> (iii) the use of the property by the taxpayer, economic performance occurs as the taxpayer uses such property.

[39]See note 37, *supra*.

[40]1984 House Report at 1255.

[41]H.R. 4170, 98th Cong., 2d Sess., sec. 91(a), *reprinted in* 1984 House Report. In the bill, employee benefits subject to the rules of sections 404 (dealing with certain deferred compensation plans), 404A (dealing with foreign deferred compensation plans), and 419 (dealing with defined welfare benefit funds) were excepted from the economic performance rules of proposed section 461(h).

[42]The Senate bill was similar to the House version, defining economic performance as payment to another person for the same three named categories of liabilities. That bill included the same exceptions (see note 41, *supra*) and added another: if payments were made within 2½ months after the close of the taxable year, the special rule for "employee benefit liabilities" was not to apply. Thus, in such a case, economic performance would be defined as the time of services, not the time of payment. S. 2062, 98th Cong., 2d Sess., sec. 71(a), *reprinted in* 1984 Senate Report.

[43]IRC sec. 461(h)(2)(C).

economic performance in other circumstances, it is only because regulations have so provided.[44]

The conference committee report does not explain why the statutory reference to "employee benefit liabilities" was dropped. The Supreme Court may be right in implying that economic performance and hence deduction in such cases should await payment, but that is a peculiar inference to draw from Congress' deletion of a phrase that would have unequivocally secured that result.[45] And the conference committee suggested that economic performance may occur prior to (or simultaneously with) the provision of medical services: "economic performance with respect to a liability to an employee generally occurs as the *employee* renders his or her services."[46]

We can only speculate about the reason for the deletion of the bill's reference to "employee benefit liabilities." One possibility is that the conference committee determined such a liability is likely to have a sufficiently short "tail," the time between accrual and payment, that the economic benefit from an accelerated deduction is within acceptable limits.[47] In contrast, because they may be discharged in installments over extended periods of time, worker's compensation and tort liabilities are precisely the kind of potentially abusive liabilities that most concerned many commentators.[48]

Another possible explanation, for which there is a great deal of circumstantial evidence, is that the committee concluded no special reference to "employee benefit liabilities" is necessary in section 461(h) because the timing effect of such liabilities is generally to be determined under other statutory provisions.[49] Indeed, the conference committee noted that "an employer's deduc-

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[44]See notes 19-20, *supra*, and accompanying text. The implication of this scheme is that for those events specifically addressed in the statute, such as the provision of services, regulations should redefine the time of economic performance only in special circumstances.

[45]See notes 51-80, *infra*, and accompanying text (suggesting proper post-1984 Act analysis). It is true that deferral of a deduction until payment would eliminate the premature accrual effect. See note 26, *supra*, and accompanying text. It is also true that, when there is substantial doubt about the time of economic performance, the legislative language should be interpreted in a way that reduces premature accruals. But the Court was making no argument about the proper method of interpretation in a world of uncertainty; it merely quoted language from a questionably relevant committee report.

[46]1984 Conference Report at 877 (emphasis added). The Supreme Court had cited to the conference committee report (see note 33, *supra*) as if that report supported its suggestive nonsuggestion about "employee benefit liabilities." However, the page citation is to the conference committee's description of the House bill, not to a discussion of the committee's own product. 1984 Conference Report at 872.

The 1984 Blue Book gives support to the Supreme Court's implication: "Economic performance with respect to employee benefits (other than compensation) occurs generally when the employer makes a payment under the benefit plan (rather than when the services are rendered)." 1984 Blue Book at 267. If this language is intended to explain section 461(h), however, its statutory underpinnings are obscure.

Perhaps the 1984 Blue Book language merely means that other statutory sections, such as IRC sec. 404 (see notes 53-80, *infra*, and accompanying text) may often defer deductions until payment and thus may have the effect of preempting section 461(h). So interpreted, the language would be less objectionable. However, an example provided in the Blue Book suggests that the Joint Committee staff intended the language to mean precisely what it says about the time of economic performance. See the 1984 Blue Book at 267 (contribution to trust under funded welfare benefit plan that, because of effective date of IRC sec. 419, was not governed by that section, said to be deductible only at time of payment under IRC sec. 461(h)). See note 53, *infra* (describing effect of IRC sec. 419).

If the Blue Book language was intended to explain section 461, as it apparently was, it should be given little interpretive weight since it is arguably contrary to the conference committee report. Cf. *Bank of Clearwater v. United States*, 7 Cl. Ct. 289, 2984 (1985) (emphasis added):

> It is this court's view that, although said Joint Committee Explanation prepared by the staff does not rise to the level of authority given to legislative history, we do not perceive it as totally worthless or unenlightening. It is common knowledge that the congressional staff of the Joint Com-

(Footnote 46 continued on next column.)

(Footnote 46 continued.)

> mittee works very closely with the members of Congress in drafting legislation and undoubtedly has "eyeball knowledge" of the fundamental legislative purpose of a given piece of legislation. *Absent any definitive legislative history that is more revealing*, the court believes it is proper nonetheless, *in the absence of any comparable contrary assertions*, to give substantial weight to this Explanation. At the very least, it should receive no less recognition than a thesis of a text writer on a given point.

The Blue Book is a staff-prepared report, not reviewed by either congressional tax committee. It merely reflects the staff's understanding of congressional intent. See Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, at III (Comm. Print 1976).

[47]Congress' views about what constitutes an acceptably short tail are evolving, as the change in the treatment of vested vacation pay demonstrates. The 1984 Act contained a specific provision limiting an employer's current deduction for vacation pay earned during the taxable year to amounts paid within 8½ months of that year's end. See IRC sec. 463(a), prior to repeal by Revenue Act of 1987, Pub. L. No. 100-203, sec. 10201(a), 101 Stat. 1330-382, 1330-387; cf. note 27, *supra*, and accompanying text (8½ month requirement of "recurring items" exception). However, by repealing section 463 (and making conforming changes elsewhere in the Code), Congress in the 1987 Act effectively reduced the critical period for vacation pay to 2½ months after the end of the year in which it was earned. See H.R. Rept. No. 495, 100 Cong., 1st Sess. 921 (1987) [the 1987 Conference Report].

[48]See Bradley & Winslow, *supra* note 25, at 232. In Rev. Rul. 69-429, 1969-2 C.B. 108, the Service had ruled that, in the case of a worker's compensation settlement award to be paid in installments over several years, a self-insured employer could deduct the total undiscounted amount of the future awards in the year of settlement. (For example, if the obligation were to pay $1,000 per year for 10 years, the employer could currently deduct the full $10,000, rather than the present value of the future stream of payments.) Imaginative planners urged the use of this principle in structuring tort settlements as well. See McGown, *supra* note 23, at 252-53. In certain extreme cases, it was possible to structure a settlement that, because of the value of the current, undiscounted tax deduction, provided an overall economic benefit to the payor. In response to one such example, Professor Gunn remarked, "If this is the law [prior to the 1984 Act], well-advised accrual-method businesses should cancel their liability insurance and run down pedestrians at the rate of at least one a year." Gunn, *supra* note 25, at 26.

[49]The Supreme Court's quotation from the House Report assumed, however, that IRC sec. 461(h) was to be the controlling provision. See text accompanying note 33, *supra*.

tion for compensation or other benefits paid to an employee in a year subsequent to economic performance is subject to the rules in the Code...governing deferred compensation, deferred benefits, and funded welfare benefit plans."[50] The committee suggested, that is, that even though economic performance is deemed to occur as the *employee* performs his services (subject, of course, to the Treasury's power to change the rules), other sections may require deferral of the employer's deduction beyond the time of economic performance.

In Part IV, this article attempts to locate the analysis of employee benefit liabilities like those at issue in *General Dynamics* within the new statutory scheme. As we shall see, footnote 3 is not helpful in that process.

The analysis of employee benefit liabilities is enormously complex.

IV. Unfunded Medical Reimbursement Plans

The analysis of employee benefit liabilities is enormously complex.[51] Merely locating the proper analytical starting point in the Code for a particular liability can confuse the very best lawyers.[52] This article cannot provide the definitive treatise on the deductibility of amounts related to unfunded medical reimbursement plans; it is enough for present purposes to demonstrate that the Supreme Court's suggestion about post-1984 Act law is misleading. For those lawyers educated about employee benefits, the Court has added confusion to an already confused area. For inexperienced lawyers, the Court applied a veneer of simplicity to an area that is decidedly not simple.

A. Unfunded Plans Providing Deferred Benefits

If a medical reimbursement plan is unfunded,[53] and if the plan provides "deferred benefits," then, under section 404,[54] the employer may deduct otherwise deductible[55] amounts only as they are includable in the gross income of employees (or as they would be includable were it not

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[50]1984 Conference Report at 877. Accordingly, since employee benefit liabilities are not included in the rule defining economic performance as payment, the House and Senate bills' references to sections 404, 404A, and 419 as exceptions to that rule were unnecessary. See notes 41-42, *supra*.

[51]Part IV of this article can only suggest the necessary complexity. The analysis of medical reimbursement plans provided here assumes the inapplicability of IRC sec. 83(h), which applies to compensation-related transfers of "property," not including money, Reg. section 1.83-3(e); and IRC sec. 404A, dealing with certain foreign deferred compensation plans. An employee benefits lawyer must of course be familiar with these sections as well as the complex provisions governing qualified benefit plans.

[52]The author has seen such issues discussed by major law firms in memoranda that ignore the effects of some of the potentially crucial Code sections. See also W. Klein, B. Bittker & L. Stone, *supra* note 37, at 437 (ignoring IRC sec. 404).

[53]"Unfunded" means, for this purpose, that the reimbursement obligation will be discharged through the use of the employer's general funds. The employer has taken no steps to segregate assets (through separate trusts, bank accounts, and so on) to meet the obligation.

Despite the "unfunded" nomenclature, we would have to assure ourselves that the arrangement did not constitute a "funded welfare benefit plan" governed by IRC sec. 419. IRC sec. 419 and its companion provision, IRC sec. 419A (dealing with qualified asset accounts), were added to the Code by the Tax Reform Act of 1984, Pub. L. No. 98-369, sec. 511(a), 98 Stat.

(Footnote 53 continued on next column.)

(Footnote 53 continued.)

494, 854-61, and were amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, sec. 1851, 100 Stat. 2085, 2858-63. If section 419 did apply, the employer would effectively be put on a cash basis, with contributions deductible (subject to some limitations) only as paid to a "welfare benefit fund."

A "welfare benefit fund" is a "fund which...is part of a plan of an employer, and...through which the employer provides welfare benefits to employees or their beneficiaries." IRC sec. 419(e)(1). "Welfare benefits," in general, are all benefits other than those governed by IRC sec. 83(h), IRC sec. 404, or IRC sec. 404A. IRC sec. 419(e)(2); see note 41, *supra* (describing other cited Code sections).

Without a segregated account or fund created specifically to cover the plan's obligations, a reimbursement plan should avoid the application of IRC sec. 419. A "fund" is in general defined as one of several enumerated tax-exempt organizations; a trust, corporation, or other taxable entity; and, "to the extent provided in regulations, any account held for an employer by any person." IRC sec. 419(e)(3). The legislative history provides some guidance on what constitutes a "fund."

> In prescribing regulations relating to the definition of the term "fund," the conferees wish to emphasize that the principal purpose of this provision...is to prevent employers from taking premature deductions, for expenses which have not yet been incurred, by interposing an intermediary organization which holds assets which are used to provide benefits to the employees of the employer.

1984 Conference Report at 1155. The House Report indicated in a footnote, however, that "employer contributions to a separate bank account of the employer or to a subsidiary or other related party would not be considered contributions to a fund." 1984 House Report at 1280 n.18.

The analysis can be particularly confusing, and the possibility of application of IRC sec. 419 therefore correspondingly greater, if the employer interposes a third party administrator, such as an insurance company, for the plan. Temporary regulations have provided:

> [I]f an employer makes a payment to an insurance company under an "administrative services only" arrangement with respect to which the life insurance company maintains a separate account to provide benefits, then the arrangement would be considered to be a "fund."

Temp. Reg. sec. 1.419-1T, A-3(c). *But see* Announcement 86-45, 1986-15 I.R.B. 52 (clarifying arrangements with insurance companies that will be classified as "funds").

[54]IRC sec. 404 was modified in both 1984 and 1986. The most noteworthy modification for present purposes was the addition of IRC sec. 404(b)(2). See note 56, *infra*. Tax Reform Act of 1984, Pub. L. No. 98-369, sec. 512(a), 98 Stat. 494, 862-63.

[55]IRC sec. 404(a) provides, in relevant part, that

> if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such...compensation shall not be deductible under this chapter; *but, if they* [*sic*] *would otherwise be deductible*, they [*sic*] shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year.

(Emphasis added.) Among the specified limitations is that of IRC sec. 404(a)(5). See note 56, *infra*.

Prior to the Tax Reform Act of 1986, IRC sec. 404(a) required that the deductions be otherwise available under either IRC sec. 162 or sec. 212. The 1986 Act substituted the less restrictive "otherwise be deductible" language. Pub. L. No. 99-514, sec. 1851(b)(2)(C)(i), 100 Stat. 2085, 2863.

for a statutory exclusion).[56] The requirement that the amount "otherwise be deductible" means not only that the expense must be an ordinary and necessary business expense (or have another statutory basis for deduction), but also that the statutory timing requirements must be met.[57] By its terms, section 404 acts only as a deferral provision: when the threshold all events test, as modified by the economic performance requirement, has been satisfied, the employer must consider whether section 404 requires still further deferral.

Integrating these statutory pieces—the all events test, the economic performance requirement, and section 404—in a simple example may be helpful. Assume that an employee performed services for an accrual-basis employer in 1987, received medical services and filed a claim for reimbursement in 1987, and is reimbursed for his medical costs under his employer's unfunded plan in 1988. Assume also that both the employer and employee have a calendar-year taxable year. The *General Dynamics* Court said the all events test is satisfied upon filing a claim for reimbursement—here 1987 (if the reasonable accuracy requirement is met at that time[58]). Under section 461(h), prior to any regulatory modification, economic performance is apparently deemed to have occurred as the employee performed his services, also in 1987.[59] But absent a statutory exclusion rule, the employee, as a cash-basis taxpayer, would have to include the reimbursed amounts in income as received, in 1988. If this plan is a deferred benefit plan—and from a common sense standpoint it is[60]—section 404 requires deferring the employer's deduction until 1988, the year of payment, despite apparent compliance with section 461(h) in 1987.

The conclusion that 1988 is the appropriate year of deduction is reinforced by another consideration. Notwithstanding the suggestion in the legislative history,[61] the economic performance requirement will not have been met in 1987. Under its statutory authority to modify section 461(h) definitions,[62] the Treasury has issued temporary regulations defining economic performance, in the case of a deferred benefit that is governed by section 404 and that is received by a cash-basis taxpayer, as the time of payment.[63]

The Supreme Court's suggestion...appears to be...accidentally right....

The analysis has come full circle. Economic performance, according to the temporary regulations, is payment. The Supreme Court's suggestion in *General Dynamics* that the employer's deduction must await the year of payment therefore appears to be right—accidentally right, to be sure, but right nonetheless.[64] So interpreted, the economic performance requirement merely leads to a result that section 404 would have provided anyway. Note also that, if section 404 applies, the "recurring items" exception to the economic performance requirement makes no difference in the result.[65] At least one commentator has suggested that the exception should apply to medical reimbursement plans.[66] Even if that is correct—and it is not at all clear[67]—section 404 should still defer the deduction until the time of payment for any deferred benefit.

Why should we care that the Supreme Court cited an irrelevant piece of legislative history if the citation points us in the right direction? Section B discusses that question.

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[56]IRC sec. 404(b)(2), *as amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, sec. 512(a), 98 Stat. 494, 862-63, requires treating "any plan providing for deferred benefits (other than compensation) for employees...as a plan deferring the receipt of compensation"—thus subject to the timing rules of IRC sec. 404(a)—and IRC sec. 404(b)(1) includes in the category of "plan" for this purpose any method or arrangement having the effect of a plan. IRC sec. 404(a)(5) in general requires deferring the deduction for an unfunded plan until "the taxable year in which an amount attributable to the contribution is includable in the gross income of employees participating in the plan." In determining timing, it is irrelevant that medical reimbursement would generally be excludable from the gross income of employees. See note 37, *supra*. IRC sec. 404(b)(2)(A).

Like the economic performance rules, IRC sec. 404(b)(2), as amended, is generally effective after July 18, 1984, the date of enactment of the 1984 Act. Tax Reform Act of 1984, Pub. L. No. 98-369, sec. 512(c), 98 Stat. 494, 863; Temp. Reg. sec. 1.404(b)-1T, A-3.

The analysis undertaken here is of reimbursement plans for employees, but IRC sec. 404(d) in general applies the same timing rules to deferred compensation and deferred benefits provided to independent contractors.

[57]Temp. Reg. sec. 1.461(h)-4T (1986) provides that, "[i]n the case of an accrual method taxpayer, a contribution or compensation satisfies the requirements of sections 162 or 212 [i.e., is deemed to "otherwise be deductible," see note 55, *supra* (1986 Act change in language of IRC sec. 404(a))] only to the extent that the all events test...and the economic performance requirement...are satisfied."

[58]The government had challenged the reasonable accuracy of General Dynamics' claimed deduction in the lower courts because the deduction exceeded the amount later paid for claims by nearly 20 percent. The government was unsuccessful, however, see *General Dynamics*, 6 Cl. Ct. at 256; 773 F.2d at 1226, and it did not raise the issue in its petition for *certiorari*. See note 8, *supra*.

[59]See note 46, *supra*, and accompanying text.

[60]It provides a deferred benefit in that the employee performed the services in 1987 but receives the benefit, the reimbursement, in 1988.

[61]See note 46, *supra*, and accompanying text.

[62]See note 19, *supra*, and accompanying text.

[63]In the case of a contribution or compensation subject to section 404... , pursuant to the authority under section 461(h)(2), economic performance occurs...in the case of a plan subject to section 404, either as the contribution is made under the plan or, if section 404(a)(5) is applicable, as an amount attributable to such contribution is includible in the gross income of an employee.

Temp. Reg. sec. 1.461(h)-4T, A-1 (1986).

[64]The temporary regulations were promulgated on January 29, 1986, in T.D. 8073, 1986-1 C.B. 42, and thus were available long before the Supreme Court's decision in *General Dynamics*. A citation to these regulations would have been more helpful to readers than the Court's citation to the House Report.

[65]See notes 27-29, *supra*, and accompanying text.

[66]See Note, "Tightening the Prongs on the 'All Events' Test: *United States v. General Dynamics Corp.*," 41 *Tax Lawyer* 523, 538 (1988).

[67]See text accompanying note 28, *supra*.

Table 1

Deductibility of Claims for Medical Services Performed in 1987

(1) Filing of Claim (All Events Test Met)[1]	(2) Payment of Claim	(3) Deferred Benefit? (Sec. 404 Apply?)	(4) Economic Performance (If Not a 'Recurring Item')[2]	(5) Year of Deduction[3]
1987	Before 3/16/88	No	1987 (services)	1987 (All events test and economic performance have occurred; sec. 404 does not apply)
1987	After 3/15/88	Yes[4]	1988 (payment)	1988 (Sec. 404 controls)
1988	Before 3/16/88	No	1987 (services)	1988 (All events test not met until filing)
1988	After 3/15/88	Yes[4]	1988 (payment)	1988 (Sec. 404 controls)

[1]Assuming amount of liability prong is satisfied.
[2]If "recurring items" exception is applicable, the unmodified economic performance requirement does not apply.
[3]Whether or not "recurring items" exception applies.
[4]Assuming presumption that payments were made more than "brief period" after end of year cannot be rebutted.

B. What Are Deferred Benefits?

As convoluted as the above statutory analysis may seem, the real world is even more complex. We should care about the Court's sloppiness because the Court may well not have pointed us in the right direction. A more detailed statutory map is necessary, and some of the terrain is yet to be charted. The above analysis was premised on the assumption that a medical reimbursement plan is necessarily a deferred benefit plan.[68] However, under the temporary regulations, and with support in the legislative history,[69] benefits are treated as deferred only if they are received more than a "brief period of time" after the end of the employer's taxable year,[70] and a plan is presumed to defer benefits for more than a brief period only if they are received more than 2½ months after the close of that year.[71]

The hypothetical medical reimbursement plan therefore is not necessarily a deferred benefit plan. Suppose the plan by its terms required that all claims for medical services received in 1987 be filed in time that the claims could be paid by March 15, 1988. In such a case, no benefits were deferred more than a brief period beyond the end of 1987, and section 404 therefore would not apply. The timing of the employer's deduction would be governed solely by the all events test, as modified by the economic performance requirement. For those claims filed in 1987 under the plan, the fact of liability was then fixed. The temporary regulations do not specify that economic performance occurs upon payment in the case of an unfunded plan not governed by section 404.[72] The statutory definitions of economic performance should therefore control: economic performance occurred in 1987 with the performance of services. Accordingly, with the all events test satisfied and economic performance having occurred in 1987, the employer should have been

[68]See *Accounting Periods and Methods*, Para. 203.031, at 370 (CCH Tax Transactions Library) (T.J. Purcell ed. 1987) (apparently assuming that medical reimbursement plans are governed by deferred benefit rules).

[69][T]he conferees intend that payment of bonuses or other amounts within 2½ months after the close of the taxable year in which significant services required for payment have been performed is not to be considered a deferred compensation or deferred benefit plan.

1984 Conference Report at 1160. See also 1984 House Report at 1284 ("brief period" rule); 1984 Blue Book at 805 (to same effect). The Senate version of the bill would have codified the 2½ month standard. See note 42, *supra*.

[70]Temp. Reg. sec. 1.404(b)-1T, A-2(a) (1986).

[71]Temp. Reg. sec. 1.404(b)-1T, A-2(b)(1) (1986). The regulatory 2½ month rule, first alluded to in legislative language later dropped (see note 42, *supra*), overturned the prior position of the Internal Revenue Service, under which a plan was treated as a deferred compensation or deferred benefit plan only if it deferred a payment for more than 12 months after the close of the taxable year in which the employer incurred a liability under the plan. See, e.g., LTR 82-06-169 (Nov. 17, 1981); LTR 80-06-067 (Nov. 19, 1979) (citing *New York Seven-Up Bottling Co. v. Commissioner*, 50 T.C. 391 (1968) (severance pay plan held to be deferred compensation plan where it provided employees terminating after more than five years' continuous service with one week's pay for each year of service); and *Lundy Packing Co. v. United States*, 302 F. Supp. 182 (C.D.N.C. 1969), *aff'd per curiam*, 421 F.2d 850 (4th Cir. 1970) (sick pay plan held to be deferred compensation plan where it entitled the employee to

(Footnote 71 continued on next column.)

(Footnote 71 continued.)

one week's pay per year when unable to work or upon termination of employment). See also Letter from Calvin H. Johnson to David Brockway (July 2, 1985) (criticizing vagueness of definition of "deferred" (prior to issuance of temporary regulations) and resultant possibility of planning severely premature accruals), *reprinted in* 28 *Tax Notes* 920 (1985).

Congress gave its stamp of approval to the 2½ month period when, in the Revenue Act of 1987, it repealed IRC sec. 463, dealing with the accrual of vested vacation pay. See note 47, *supra*. No Code section specifically provides for the 2½ month grace period. Nevertheless, the committee reports assume that, without section 463, an employer can deduct vacation pay in the year earned if it is in fact paid within 2½ months of that year's end. See 1987 Conference Report at 921; S. Rept. No. 63, 100th Cong., 1st Sess. 144 (1987) [the 1987 Senate Report].

The temporary regulation merely creates a presumption. If benefits are provided outside the 2½ month period, the employer may seek to demonstrate that the benefits were nonetheless provided within a "brief period of time." To rebut the presumption, the employer must show that it was impracticable, either administratively or economically, to avoid the further deferral and that, as of the end of the taxable year, the impracticability was unforeseeable. Temp. Reg. sec. 1.404(b)-1T, A-2(b)(2) (1986).

[72]See note 63, *supra*.

entitled to a deduction in that year, even if payment was not made until 1988.[73]

It may seem perverse that the effect of this analysis is to permit an employer a deduction, in some circumstances, earlier for an unfunded plan than it would be entitled for a contribution to a "funded welfare benefit plan."[74] This shows only that perversity and the Internal Revenue Code are not mutually exclusive.

This shows only that perversity and the Internal Revenue Code are not mutually exclusive.

Add another real world assumption. Suppose the plan did not require that all reimbursements attributable to 1987 medical services be made by March 15, 1988; perhaps, in the interest of labor harmony, the employer wished to honor late claims.[75] The plan thus provided deferred benefits,[76] but not all of the benefits were deferred. Many claims were in fact paid by the end of the 2½ month period, but others were not. Is the overall medical reimbursement plan now simply a deferred benefit plan, so that section 404 governs the timing of deductions for all reimbursed claims under the plan? Or perhaps the plan should be bifurcated: those claims for 1987 expenses paid by March 15, 1988, were potentially deductible in 1987, while claims paid after that date are treated as deferred benefits, deductible only on payment.

The answer is not totally clear under the temporary regulations, but it appears either that bifurcation is appropriate[77] or, perhaps even more surprising, that each employee should be treated as having his or her own "plan."[78] Under either line of analysis—whether the medical reimbursement scheme is chopped into two pieces or splintered still further for analytical purposes—the Supreme Court's suggestion is wrong. The self-insurer's liability for some claims could be deductible prior to the year of payment, assuming that the reasonable accuracy of the claimed deductions (the *amount* of the liability) can be demonstrated.[79]

Imaginative tax planning did not die with footnote 3 of *General Dynamics*. Consistent with its method of accounting,[80] a careful taxpayer may still be able modestly to accelerate deductions associated with unfunded medical reimbursement plans. In light of this analysis, Table 1 outlines the tax treatment of claims arising from medical services provided in 1987 to employees of a self-insured, accrual-basis taxpayer that has the calendar year as its taxable year.

V. Conclusion

The Supreme Court did mislead us. Classification of a liability as an "employee benefit liability" merely begins a complex analysis, an analysis full of uncertainties. Despite the Court's implication, economic performance does not necessarily occur at the time (and for the reason) stated in footnote 3 in *General Dynamics*, and the time of economic performance might well not be a controlling consideration in any event.

Because of these complexities and uncertainties, the Court's suggestion in *General Dynamics* was particularly inappropriate. The Court prides itself on leaving issues not before it for another day. The treatment of unfunded medical reimbursement plans under post-1984 Act law was an issue that should not have been discussed in the *General Dynamics* opinion. By offering gratuitous advice, the Court demonstrated nothing but the wisdom of its usual policy of restraint.

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[73]As before, if the recurring items exception applies, it makes no difference in the result. See text accompanying note 65, *supra*. Even if the economic performance requirement need not be met, the year of deduction remains 1987, when the all events test was satisfied.

[74]See note 53, *supra* (IRC sec. 419 defers such a deduction until year of payment to fund).

[75]General Dynamics honored claims that were filed substantially later (as much as two years) than required under the terms of the plans. Joint Appendix at 131, *General Dynamics* (No. 85-1385).

[76]Under these circumstances it does not appear possible to rebut the presumption that the benefits were paid outside the "brief period." See note 71, *supra*. At the end of 1987, it would have been foreseeable that late payments were to be made. See note 71, *supra*.

[77]Bifurcation is supported by the legislative history associated with the repeal of IRC sec. 463. See notes 47 and 71, *supra*. The 1987 Conference Report suggests that vested vacation pay not paid in the year earned should be divided into two components. For employees in the aggregate, the part of any vacation pay paid within 2½ months of year's end would be deductible in the year earned; the rest would become deductible only upon payment. 1987 Conference Report at 921. Congress viewed this treatment as exemplifying a more general principle: the reason for the repeal of section 463 was to eliminate "the disparity in tax treatment between vacation pay and other deferred benefits." 1987 Senate Report at 144.

[78]The temporary regulations provide that "[b]enefits are 'deferred benefits' if, assuming the benefits were cash compensation, such benefits would be considered deferred compensation." Temp. Reg. sec. 1.404(b)-1T, A-2(b)(1) (1986). And the regulations provide a relevant example of a cash arrangement whose possible treatment as deferred compensation is determined employee-by-employee:

> [S]alary or a year-end bonus received beyond the applicable 2½ month period by one employee shall be presumed to constitute payment under a plan, or method or arrangement, deferring the receipt of compensation for such employee even though salary or bonus payments to all other employees are not similarly treated because they are received within the 2½ month period.

Id.

[79]The amount of liability question did not receive Supreme Court scrutiny in *General Dynamics*, although it should have been examined. See Jensen, *supra* note 3, at 246-249; Sheppard, *supra* note 24, at 340 ("*General Dynamics*...appears to be a reasonable accuracy case decided as a fixed liability case."); note 58, *supra*. Without guidance on this point, it is difficult to know how much further uncertainty the amount of liability issue will add in the typical real world situation. For those inclined to take an aggressive stance, it is certainly helpful that General Dynamics prevailed on this issue in the lower courts. See note 58, *supra*.

[80]Conforming to the requirements of *General Dynamics* may constitute a change in method of accounting for some taxpayers, and the Secretary of the Treasury's permission may therefore be required for the change. IRC sec. 446(e).