The Supreme Court’s Misleading Footnote in General Dynamics

Erik M. Jensen
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., involving a casino's deduction of the net increase in its progressive jackpot obligations for the year, and United States v. General Dynamics Corp., 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. 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. 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. 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

176 U.S. 593 (1986).
3The 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).
4The 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.
5For 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 benefits." 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 allocable liability in the current taxable year. 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." As Hughes Properties and General Dynamics reached the Supreme Court, both cases implicated only the first prong of the test, the fact of liability. 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.

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

The fact of liability 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. 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.

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.

General Dynamics prevailed in the lower courts, 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.

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 approved, the taxpayer must generally show the absence of contingencies, other than the obligor's ability to pay, that could defeat the obligation.

19General 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). Cit. Brooke, Dirig & Yulas, "Taxation of HMOs After Section 461(h) and General Dynamics," 58 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, 268 (1986).

20General 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.

21See Petition for Writ of Certiorari at 8, General Dynamics (No. 85-1855).

22General Dynamics Corp. v. United States, 6 Cl. Ct. 250 (1984), aff'd, 773 F.2d 1224 (Fed. Cir. 1985).

23General 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, section 461(h) requires that a deduction generally be taken no earlier than “economic performance.” 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. 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. The Secretary of the Treasury is given authority to provide exceptions to these rules and also to define economic performance for cases not specifically covered by the statute.

Section 461(h) generally operates to defer deductions beyond the time that they could have been taken under pre-1984 Act law. 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.”

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, and no Code provision or judicial decision has limited a taxpayer to a discounted deduction in such circumstances.

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....”
of the future value. 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—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.

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." 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, economic 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?

III. Footnote 3

The economic performance requirement did not apply in either Hughes Properties or General Dynamics. 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.

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, 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."

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. 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

Footnote 3


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.

IRC sec. 461(h)(3)(A).

Bowers & Stone, supra note 21, at 356.

Footnote 4

See notes 75-80, infra, and accompanying text (discussing similar issues under IRC sec. 404).

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

See Jensen, supra note 5, at 911-12.

I suspect that is one of the reasons for the footnote.


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).
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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 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. That
time, however, is not uniformly reflected in the defini-
tions of economic performance. The statute by its terms
permits the deduction of many liabilities before payment
occurs, and there is nothing obviously peculiar about
services provided in connection with "employee benefit
liabilities" that justifies treatment different from the provi-
sion of services generally.

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. The
government could argue that the medical services (assum-
ing those are the critical services for analytical pur-
poses) 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 liabili-
ties, which require a payment by the taxpayer to another
person, economic performance occurs as the payments
to such person are made." That passage interprets
language in the House bill that said precisely the same
thing—language applying to the three named categories
of liabilities. 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.

The Code section as enacted treats "payment" as the
event of economic performance only for worker's com-
ensation and tort liabilities. If "payment" is to constitute

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33See note 26, supra, and accompanying text.

34See notes 17-20, supra, and accompanying text. Under the
statute, economic performance is defined as occurring on pay-
ment only with respect to worker's compensation and tort
liabilities. IRC sec. 461(h)(2)(C).

35If there are hidden peculiarities that should have controlling
effect, the Court did not enlighten us about them. Two possibili-
ties 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.
(assuming performance of medical services is controlling). But
see note 46, infra, and accompanying text (1984 Conference
Report suggesting economic performance occurs as the em-
ployee 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 in-
come by the employee. Several Code provisions seek to ensure
"inter-taxpayer matching," deferring a deduction until a corre-
sponding inclusion occurs. See, e.g., IRC sec. 83(h) (deferring
deduction attributable to compensation-related transfer of prop-
er) 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. 106(b). But see IRC sec. 89 (new provi-
sion denying exclusion of benefits to highly compensated em-
ployees if benefit plan is discriminatory).

36IRC 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.
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. 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.

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. Indeed, the conference committee noted that "an employer's deduct-

(Footnote 46 continued.)
The analysis of employee benefit liabilities is enormously complex.

IV. Unfunded Medical Reimbursement Plans

The analysis of employee benefit liabilities is enormously complex. The proper analytical starting point in the Code for a particular liability can confuse the very best lawyers. 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, and the plan provides "deferred benefits," then, under section 404, the employer may deduct otherwise deductible amounts only as they are includable in the gross income of employees (or as they would be includable were it not

(Footnote 53 continued.)

1984 Conference Report at 877. Accordingly, since employee benefit liabilities are not included in the rules 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.

19 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. sec. 1.83-3(e); and IRC sec. 404A, dealing with certain deferred compensation plans. An employee benefit lawyer must of course be familiar with these sections as well as the complex provisions governing qualified benefit plans.

20 The author has seen issues discussed by major law firms in memoraanda 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).

21 "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. 418 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. 671.

(Footnote 53 concluded on next column.)
for a statutory exclusion. 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. 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). 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. 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—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, the economic performance requirement will not have been met in 1987. Under its statutory authority to modify section 461(h) definitions, 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.

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. 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. At least one commentator has suggested that the exception should apply to medical reimbursement plans. Even if that is correct and it is not at all clear—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.

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

See note 46, supra, and accompanying text.

See note 19, supra, and accompanying text.

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.


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.

See notes 27-29, supra, and accompanying text.


See text accompanying note 28, supra.
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 1988. Senate 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. 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

(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 2 1/2 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 2 1/2 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 2 1/2 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 2 1/2 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).

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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 slipshodness 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. However, under the temporary regulations, and with support in the legislative history, 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, and a plan is presumed to defer for more than a brief period only if they are received more than 2 1/2 months after the close of that year.

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).

The conferees intend that payment of bonuses or other amounts within 2 1/2 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); 1986 Blue Book at 805 (to same effect). The Senate version of the bill would have codified the 2 1/2 month standard. See note 42, supra.

The temporary regulation sec. 1.404(b)-1T, A-2(b)(1) (1986). The regulatory 2 1/2 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)).

(1) Deferred Benefit? (Sec. 404 Apply?)
(2) Economic Performance (If Not a Recurring Item)
(3) Filing of Claim (All Events Test Met)" (4) Payment of Claim (Sec. 404 Apply?)
(5) Year of Deduction

<table>
<thead>
<tr>
<th>Year</th>
<th>Deferred Benefit?</th>
<th>Economic Performance</th>
<th>Filing of Claim (All Events Test Met)</th>
<th>Payment of Claim (Sec. 404 Apply?)</th>
<th>Year of Deduction</th>
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</thead>
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<td>1987</td>
<td>No</td>
<td>NRT</td>
<td>Before 3/16/88</td>
<td>1987 (services)</td>
<td>1987 (Services)</td>
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<tr>
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<td>After 3/15/88</td>
<td>1988 (Sec. 404 controls)</td>
<td>1988 (Sec. 404 controls)</td>
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<tr>
<td>1986</td>
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<td>1987 (services)</td>
<td>Before 3/16/88</td>
<td>1988 (All events test not met until filing)</td>
<td>1988 (Sec. 404 controls)</td>
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<tr>
<td>1986</td>
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<td>1988 (payment)</td>
<td>After 3/15/88</td>
<td>1988 (All events test not met until filing)</td>
<td>1988 (Sec. 404 controls)</td>
</tr>
</tbody>
</table>

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

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entitled to a deduction in that year, even if payment was not made until 1988.\textsuperscript{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."\textsuperscript{74} This shows only that perversity and the Internal Revenue Code are not mutually exclusive.

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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.\textsuperscript{75} The plan thus provided deferred benefits,\textsuperscript{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.\textsuperscript{77}

The answer is not totally clear under the temporary regulations, but it appears either that bifurcation is appropriate\textsuperscript{78} or, perhaps even more surprising, that each employee should be treated as having his or her own “plan.”\textsuperscript{79} 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.\textsuperscript{80}

Imaginative tax planning did not die with footnote 3 of General Dynamics. Consistent with its method of accounting,\textsuperscript{81} 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.

\textsuperscript{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.

\textsuperscript{74} See note 53, supra (IRC sec. 419 defers such a deduction until year of payment to fund).

\textsuperscript{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).

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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.

\textsuperscript{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).