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# CURRENT DEVELOPMENTS IN THE TAXATION OF COMPENSATION FOR SERVICES RENDERED

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The impact of taxation on management decisions has been brought forcefully to the attention of the general public recently in an article that was most critical of the extent to which business matters are tailored to accomplish a favorable tax result.<sup>1</sup> There is probably no other area of industry concern where the tax consequences play a more important part than in considering methods of paying compensation. An inordinate amount of time is being spent by industry tax experts in attempting to devise means for ameliorating the effects of the high progressive surtax rates. Many of the recent corporate resolutions authorizing payments to employee's beneficiaries owe their strange construction to an attempt to preserve a tax deduction for the payor of what is hoped will be treated as a non-taxable gift to the payee. Pension plans are now designed to comply with specific provisions of the tax law and many even permit a lump sum withdrawal in one year of all credits solely to obtain a capital gains privilege for participants. Disability wage plans are being subjected to a thorough review with an eye toward the pertinent provisions of the significant tax law change in 1954.

The tax consequences to employees may make or break any compensation plan which, from solely a business standpoint, seems desirable. If the cost of a plan to a company is fixed, the method of payment and the conditions attached to receipt should be set up so that the best net of tax result will be obtained for the employees. These factors require that corporate tax counsel devote considerable time and study to the taxation of individuals. For that reason a review of current developments with respect to the taxation of various types of compensation payments should be appropriate in a symposium devoted to the tax problems of industry.

## I. INCENTIVE PLANS

The earlier compensation plans designed to increase employee's incentive, particularly of key management, date back to the early 1900's.<sup>2</sup> Payment of compensation in stock of the employer and profit-sharing were the principal devices employed. The standard stock bonus plan provided for

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\*This article is not to be considered the official view of the company with whom the author is associated.

1. Hawley, *Our Tax Laws Make Us Dishonest*, Sat. Eve. Post, July 14, 1956, p. 27.

2. The present bonus plan of E. I. du Pont de Nemours & Company has been continuously in operation since 1904. United States Steel Corp. adopted an incentive plan in 1902. See BAKER, *EXECUTIVE SALARIES AND BONUS PLANS 193-95* (1938).

an award in stock for each year with the amount based on performance and profits of the company. The stock was deliverable over a period of time with provisions for forfeiture on termination of service prior to delivery. Early profit-sharing plans usually provided for a formula distribution of profits to key personnel who were entitled to specified percentages. Many of these plans were originally adopted at a time when little or no consideration needed to be given to tax matters. Now many incentive plans have been so amended and revised that they may be more accurately characterized as tax minimization plans.<sup>3</sup>

#### A. Stock Bonus

Stock bonus plans have been rendered almost useless as a means of creating a substantial stock interest for management.<sup>4</sup> This is because an employee must sell stock received as compensation in order to pay tax on the fair market value of the stock at time of receipt. Employers just cannot make up the tax and attempts to do so often result in total compensation which approaches recognized maximums.<sup>5</sup>

The old line stock bonus plan which envisions the award of stock to employees in one year, followed by delivery in subsequent years on an earning out basis, affords no unusual tax problems so long as each employee's interest in an award is forfeitable and no accrual or payment is made by the employer prior to the time of actual delivery of the stock. The employee realizes taxable income based on the fair market value of the stock at time of receipt. The employer obtains a tax deduction for the same amount in the year when it is paid or accrued.<sup>6</sup> Amounts which are paid to the employees as dividends on awarded stock are deductible by the employer as compensation.<sup>7</sup>

The use of treasury stock under such plans or under any plan of compensation will not result in gain or loss to the Company under final

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3. The principal means of minimizing tax is to defer the receipt of benefits to post employment years when the effective tax rate will be lower. Increased personal and corporate taxation has been found to be one of the most important factors in the growth among large corporations of deferred-type compensation plans. HALL, *EXECUTIVE COMPENSATION AND RETIREMENT PLANS* 55 (1951).

4. Wentz, *Remedying the Effect of Taxation on Management Ownership of Corporate Stock*, 48 NW. U. L. REV. 442 (1953).

5. The Internal Revenue Service holds that each reimbursement of tax is itself taxable income. *Mim.* 6779, 1952-1 CUM. BULL. 8 and *I.R.-Mim.* 51, 1952-2 CUM. BULL. 65. In *Connecticut Ry. & Lighting Co. v. United States*, 142 F. Supp. 907 (Ct. Clms. 1956) it was held that only the first reimbursement of tax was taxable. The basis for the holding is not clear because of a question of discrimination against the taxpayer involved by reason of the Commissioner's retroactive application of the above cited mimeographs.

6. If payments are made under a plan deferring the receipt of compensation, the deduction cannot be taken prior to the year of actual payment even though liability may accrue in an earlier year. *INT. REV. CODE* of 1954, § 404(a)(5). In order to be deductible at all, such payments must meet the "reasonableness" test of § 162. See *R. J. Reynolds Tobacco Co.*, 15 CCH *Tax Ct. Mem.* 810 (1956).

7. *United States Steel Corp.*, 2 T.C. 430 (1943).

regulations promulgated by the Treasury.<sup>8</sup> For years prior to 1954, the taxability of gain or deductibility of loss on treasury stock paid for services rendered or sold to employees may be a debated point. Applicable regulations provided that a corporation realized gain or loss on disposition of treasury stock if it thereby was dealing in its shares as it would the shares of another corporation.<sup>9</sup> The Internal Revenue Service for a long time held that such was the case in any situation where stock was disposed of for a purpose other than to readjust capital.<sup>10</sup>

The Supreme Court refused to apply the rule so broadly in *U. S. v. Anderson, Clayton and Co.*<sup>11</sup> While that case involved a formal sale of stock to employees, a principle which would seem to be equally applicable to compensation was laid down. The Supreme Court said that where a transaction is limited to a wholly intracorporate purpose, with no element of speculation or gain to be derived from dealing in its shares, the corporation is not dealing in its shares as it would in the shares of another corporation.

In enacting the Internal Revenue Code of 1954, Congress completely disowned the dealing in its own shares test.<sup>12</sup> Under Sec. 1032, a company realizes no gain or loss on transfer of its own shares for money or other property. Despite this, the Treasury proposed regulations which provided that gain or loss would be recognized where treasury stock was paid for services rendered if the transfer involved dealing in the payer's shares as it would in the stock of another company.<sup>13</sup> After considerable protest this provision was dropped completely and final regulations now specifically provide that a transfer of treasury stock to employees as compensation is a tax-free disposition under Section 1032.

A recent court opinion dealing with two taxpayers who were found to have received non-taxable gifts of stock transferred to them by the majority stockholders of a corporation is of interest.<sup>14</sup> The peculiar facts of that case may not be duplicated, but the ramifications of the holding should not be ignored. The court of appeals does not even discuss the reasons for the "gifts" which the lower court had found to be com-

8. U.S. Treas. Regs. 118, Sec. 1.1032-1(a).

9. U.S. Treas. Reg. 118, § 39.22(a)-15(b) (1953).

10. The Tax Court determined the tax consequences by reference to the motive for the disposition. *The Timkin-Detroit Axle Co.*, 21 T.C. 769 (1954). However, the Courts of Appeal consistently reversed and agreed with the Commissioner that the disposition of shares which were not actually retired and reissued was taxable except in the case of capital readjustment. *Commissioner v. Landers Corp.*, 210 F.2d 188 (6th Cir. 1954); *Commissioner v. H. W. Porter & Co.*, 187 F.2d 939 (3rd Cir. 1951); *Commissioner v. Rollins Burdick Hunter Co.*, 174 F.2d 698 (7th Cir. 1949); *Commissioner v. Batten, Barton, Durstine & Osborne, Inc.*, 171 F.2d 474 (2d Cir. 1949); See Fager, *Watch Out For Treasury Stock*, 27 TAXES 719 (1949).

11. 350 U.S. 55 (1955).

12. S. REP. No. 1622, 83d Cong., 2d Sess. 426 (1954).

13. Proposed Rule Making, 20 Fed. Reg. \_\_\_\_\_ (1956) Sec. 1.1032-1(b). See Carlisle, *Treasury Stock and Sec. 1032*, 23 Geo. Wash. L. Rev. 558 (1955).

14. *Neville v. Broderick*, 235 F.2d 263 (10th Cir. 1956).

pensatory.<sup>15</sup> Rather, it stresses the constant contemporaneous references to the transfers as gifts and the failure of the payors to claim tax deductions as business expenses. There is, of course, a legal presumption that the transfer of stock or cash to an employee is for services rendered.<sup>16</sup> That this presumption could be overcome by having the controlling shareholders of a closely held corporation make the transfer in their names may be surprising to the tax practitioner who has been so long schooled in the "substance over form" doctrine.<sup>17</sup>

### B. Stock Options

The stock option is closely related to the stock bonus as a method of compensation and has long constituted a popular method of providing incentive. Originally the Treasury Department ruled that an employee realized taxable income based on the difference between the amount paid for the stock and its fair market value only to the extent such difference was in the nature of compensation for services rendered or to be rendered.<sup>18</sup> Thus, where it could be shown that an option was granted to an employee solely for the purpose of enabling him to acquire investment in the Company, the purchase was said to be for proprietary purposes and no tax was asserted.<sup>19</sup> However, use of the employee stock option became very limited subsequent to a Supreme Court decision in 1945,<sup>20</sup> which was followed by the adoption of Treasury Regulations that held that, in any case where the amount paid by an employee to his employer was less than the fair market value of the property at time of purchase, the difference was taxable compensation.<sup>21</sup> The courts refused to accept this amendment and continued to recognize a distinction between proprietary and compensatory options.<sup>22</sup>

In *Commissioner v. Lo Bue*,<sup>23</sup> the Supreme Court granted certiorari in a case involving the assertion of tax on the exercises of a stock option

15. *Neville v. Broderick*, 133 F. Supp. 716 (D.C. Kan., 1955).

16. *Wallace v. Commissioner*, 219 F.2d 855 (5th Cir. 1955); *Willkie v. Commissioner*, 127 F.2d 953 (6th Cir. 1942).

17. *Gregory v. Helvering*, 293 U.S. 465 (1935).

18. I.T. 3204, 1938-2 CUM. BULL. 126, Regs. 111, Sec. 29.22(a)-1 (1945).

19. *Geeseamen*, 38 BTA 258 (1938); And see *Rosshelm v. Commissioner*, 92 F.2d 247 (3d Cir. 1937); *Springford*, 41 BTA 1001 (1940); *Adams*, 39 BTA 387 (1939); *Evans*, 38 BTA 1406 (1938).

20. *Commissioner v. Smith*, 324 U.S. 695 (1945). There the court held that an employee realized taxable income to the extent of the difference between option price and fair market value at time of exercise of the option. The court stated that while, under some circumstances, the grant of an option could be considered the taxable event, the facts before the court indicated that compensation was contemplated from the exercise of the option since the option, at time of grant, had no ascertainable value. See note, *Employee Stock Options and the Smith Case*, 1 TAX L. REV. 225 (1945).

21. U.S. Treas. Reg. 111, § 29.22(a)-1 (1943), as amended, T.D. 5507 CUM. BULL. See Miller, *The Treasury's Proposal To Tax Employee's Bargain Purchases*: T.D. 5507, 56 YALE L.J. 706 (1947).

22. *Commissioner v. Lo Bue*, 223 F.2d 637 (3d Cir. 1955); *McNamara v. Commissioner*, 210 F.2d 505 (7th Cir. 1954); *Commissioner v. Bradner*, 209 F.2d 956 (6th Cir. 1954). And see Note, *The Non-Restricted Employee Stock Option—An Executive's Delight*, 11 TAX L. REV. 179 (1956).

23. 351 U.S. 243 (1956).

which had been granted in 1944, and which both lower courts had found was designed to provide the employee with a proprietary interest in his employer's business. The distinction between proprietary and compensatory options was laid firmly to rest by the court, which stated that there was no statutory basis for such a test. The court found that the employee received a substantial benefit prompted by his employer's desire to get better work from him. The spread between option price and value at date of exercise was held to be taxable compensation.

Some hope for an ultimate change in the peculiar method of applying tax at the time an option is exercised, rather than at the time of grant, was generated by the concurring and dissenting opinion in the *Lo Bue* case. It is pointed out that, at the time of exercise of an option, the corporation gives nothing to the employee but simply satisfies a previously created legal obligation. The taxable event arising from the payment of compensation in the form of a stock option occurs when the employee's right to exercise becomes unconditional. It is then, in the view of at least two Justices of the Supreme Court, that compensation is realized to the extent of the value of the option.<sup>24</sup> While Justice Black, speaking for the majority, did reiterate a prior statement in the *Smith* case that the value of an option could, in some circumstances, be taxable at the time of grant, he relies simply on prior Treasury practice which had been approved in the *Smith* case and the adoption by Congress of the same standard for the measurement of gains in enacting the restricted stock option provisions under which tax may apply at the time of exercise rather than at the time of grant of the option.

The amendment to allow special tax treatment of options which qualify as restricted stock options within the meaning of the Internal Revenue Code recognized the need to alleviate the *Smith* case rule in cases where employees are granted options as incentive devices.<sup>24(a)</sup> The exercise of a restricted stock option does not result in taxable compensation to an employee. The stock purchased is treated just as any other capital asset in his hands.<sup>24(b)</sup>

The only serious problem of current interest in this area may be encountered by the estate or heirs of employees who die without having exercised a restricted stock option, which may be exercisable by the estate. The value of such an option at date of death would be includible in gross

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24. *Id.* at 805. In *Palmer v. Commissioner*, 302 U.S. 63, 69 (1937) the Supreme Court, in interpreting §§ 111, 112 and 113 of the Revenue Act of 1928 said: "It follows that one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and that taxable gain does not accrue to him before he sells or otherwise disposes of it." See MAGILL, *TAXABLE INCOME* 141 (1945). The opinion in the *Smith* case, note 19 *supra*, referred to the *Palmer* case in passing, but made no attempt to distinguish it.

24(a). S. Rep. No. 2375, 81st Cong. 2d Sess. 59 (1950).

24(b). INT. REV. CODE OF 1939 § 130A. For discussions of the provisions and their genesis see Lyons, *Employee Stock Options Under the Revenue Act of 1950*, 51 COL. L. REV. 1 (1951) and Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165 (1951).

estate for federal estate tax purposes, but no income tax deduction would be allowed for the estate tax paid on a restricted stock option which does not involve the payment of income tax based on the spread between option price and the fair market value at date of grant.<sup>25</sup> North does the option acquire a stepped-up basis because of passage through the estate.<sup>26</sup> Various organizations have recommended the passage of remedial legislation<sup>27</sup> but as things now stand, taxpayers in high income brackets could realize an actual financial loss from failure to exercise favorable options prior to death.<sup>28</sup>

The Treasury has only recently issued proposed regulations dealing with non-restricted stock options.<sup>28[a]</sup> An employee is held to realize taxable compensation based on the difference between the amount paid and the value of the property at the time of transfer of property pursuant to the exercise of such an option. This rule applies to any option granted in connection with employment even though it may have been granted by a stockholder of the employer and irrespective of whether it was granted to the employee. An unusual provision of these regulations provides that where the transferee does not acquire "full ownership" of the property at time of transfer, taxable compensation is realized only when full ownership is acquired. These rules mean that an employee may be held taxable even though he acquires no interest in the property but if ownership is restricted, tax may be postponed indefinitely even until retirement. The regulations contemplate that these rules will apply even though the option may be transferable. This would seem to be a complete rejection of the idea that an employee can ever be held to realize income at the time of grant of an option even though it may at that time have a readily ascertainable market value.

Present day stock purchase plans do not involve the receipt of an immediate direct economic benefit by the employee. Because of the rule that the excess of fair market value of the stock purchased over the amount paid constitutes taxable compensation to the employee, the advantage of stock purchase plans is confined to the long-term installment payment

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25. Where the restricted stock option price at date of grant was less than 95% of the then fair market value of stock, taxable compensation is realized at time of disposition of the stock or at death if the option has been exercised. It is only to the extent of such income that a deduction can be taken for the estate tax paid because of the inclusion of the value of the option in gross estate. INT. REV. CODE OF 1954, § 421(d)(6)(B) and 691 (c)(2)(B).

26. INT. REV. CODE OF 1954, § 1014(d).

27. For example, see H.R. Rep. No. 7193 (introduced by Rep. Simpson), 83rd Cong., 1st Sess. (1953).

28. If an employee died prior to exercise of a 95% restricted stock option which would allow his estate to buy stock worth \$200 at time of death for \$100, estate tax would be payable on \$100. If the estate exercised the option and sold the stock before holding it for six months, it would have a short term capital gain of \$100. If the income tax and estate tax rates together exceed 100%, the estate will lose money by exercising the option. Of course, failure to exercise will mean a loss of the estate tax.

28(a). Proposed Rule Making 20 Fed. Reg. 8774 (1956) Sec. 1.421-6.

terms which are extended to employees and the repurchase obligation which the employer assumes. These advantages may be substantial ones.<sup>29</sup>

Some effort has been made in a limited number of cases to reduce the sales price of stock to employees by encumbering the resale rights. Thus, if an employee purchases stock which he cannot resell for a period of time, he can contend that he realizes no income because the fair market value of the stock, as restricted, is not in excess of the amount which a willing buyer would pay for such stock. The Tax Court has held that restrictions on resale so decrease the value of speculative stock that it has no ascertainable market value in excess of the amount paid at the time of resale to the employee.<sup>30</sup> It has further held that the employee realizes no taxable income at the time the restrictions expire, since there is no taxable event at that time.<sup>31</sup>

It is doubtful that the courts will adopt the value set by the parties in cases where a marketable security is sold at a much reduced price which cannot be established as its fair market value. However, if the stated price can be supported by expert opinion evidence, no tax should result to the employee.

### C. *Deferred Compensation*

One of the most convincing signs of the effects of taxation on management planning of compensation methods is found in the widespread pre-occupation of industry tax experts with the problem of avoiding the progressive surtax by deferring the receipt of compensation to post retirement years. The reams of material which have been printed on the subject probably outnumbered discussions of any other single tax topic.<sup>32</sup> The very fact that, in the thinking of executives, deferred compensation arrangements are regarded at all as incentives indicates the extent to which employees are influenced by tax considerations.<sup>33</sup>

The tax problems of deferring compensation cannot be resolved without legislation or final court action. The few fact situations which the Treasury has argued before the courts have not involved the popular type of

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29. See report of a speech by Henry Rothschild, Co-Author of Washington and Rothschild, *Compensating the Corporate Executive* (1951), in which he shows how much better off a particular executive could be under a stock purchase plan as compared to a stock option. N. Y. Times, May 5, 1956, p. 23, col. 6.

30. Harold H. Kuchman, 18 T.C. 154 (1954) Acq. 1952-2 CUM. BULL. 2.

31. Robert Lehman, 17 T.C. 652 (1951).

32. For example, see Rudick, *Introduction to Problems in Stock Options and Deferred Compensation*, N.Y.U. 14TH INST. ON FED. TAX 1047 and articles following. Long, *Deferred Compensation for Executives*, 24 TENN. L. REV. 285 (1956); Young, *Deferred Pay Plans—Qualified and Non-Qualified Plans*, N.Y.U. 13TH INST. ON FED. TAX 457.

33. Two surveys of executive feelings about taxation were conducted by the Harvard Business School. See SANDERS, *EFFECTS OF TAXATION ON EXECUTIVES* (1951); HALL, *EFFECTS OF TAXATION; EXECUTIVE COMPENSATION AND RETIREMENT PLANS* (1951).



deferral arrangements.<sup>34</sup> And yet, more and more companies are adopting plans which have as their principal purpose a lower tax rate in the year of receipt. Counsel throughout the country must be giving the green light to such plans even though there would appear to be several areas of serious doubt which could result in dire consequences to affected employees.

The more or less standard method of deferring compensation simply provides that an amount determined by reference to services rendered during the current year will be paid to the employee in annual installments after retirement. Under the usual arrangement the deferred amounts will be forfeitable on termination of employment prior to retirement. However, after retirement, payments will be non-forfeitable except where the retired employee engages in a competitive business, refuses to render consulting services or some other like condition.

There is no indication that a non-qualified deferred compensation arrangement of this type has either been specifically approved by the Treasury Department or attacked in court. Tacit approval may be assumed to some extent since Internal Revenue must have knowledge of the well publicized plans which have been adopted, and yet no statement of policy has been issued. This is not very reassuring, however. A case where the right to future payments has become non-forfeitable may not yet have arisen. Or, more seriously, the position of the Service may not have crystallized even though it is known that the subject has been under active consideration over a number of years. The absence of rulings is a clear warning that action by Internal Revenue to attempt to tax the value of deferred compensation prior to actual receipt will not require even a change in policy.

The doctrine of constructive receipt could be applied to tax deferred amounts prior to actual receipt only if it appeared that the employee had a right to payment but elected to defer.<sup>35</sup> Most deferred compensation arrangements, of course, give the employee only an implied choice. However, where annual paid compensation is reduced at the time the deferral arrangement is entered into, a court may take the view that the employee must have been consulted since it will be his tax which will be reduced by the deferral. This would be a clear extension of the constructive receipt doctrine as it is presently applied, but it may be felt to be justified

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34. See *Howard Veit*, 18 T.C. 809 (1947) and T.C.M. 919, CCH Tax Ct. Rep. 17240 (1949) and *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953). A petition was recently filed in the Tax Court in which it is indicated that Internal Revenue is contending that the execution of a compensation agreement calling for periodic payments over a number of years resulted in a taxable economic benefit. See *Clyde W. and Dorothy A. Beckner*, T.C. Docket 62095 filed May 2, 1956.

35. Under U.S. Treas. Reg. 111, § 29.42-2 (1943) income credited to the account, or set apart for a taxpayer, and which could be drawn upon by him, was subject to tax in the year so credited or set apart although it was not then reduced to possession. See *Ross v. Commissioner*, 169 F.2d 483 (1st Cir. 1948); note, 45 ILL. L. REV. 77 (1950).

in order to prevent widespread avoidance of the progressive surtax system.

The Internal Revenue Service is not limited to this theory in attempting to tax amounts which have not been reduced to possession. There is a line of cases which hold that an employee for whom an annuity contract has been purchased by his employer realizes taxable income in the year of purchase though he cannot possibly realize on the contract prior to maturity. The courts say that he has acquired a taxable "economic benefit" or "cash equivalent" at the time of purchase.<sup>36</sup> While in such cases, which involve the taxation of the present value of a promise by an insurance company to pay amounts in the future, tax has always been upheld, there has been no instance where the present value of an employer's promise to pay has been taxed prior to actual receipt.<sup>37</sup>

Most authorities feel that if one of the conditions of receipt of promised rewards is that the employee must remain in the employ of the company, the annuity cases which involve non-forfeitable rights can be distinguished so that there is no basis for tax prior to actual receipt.<sup>38</sup> The theory is that future deliveries are actually earned over the entire period of service. However, when the employee's rights become non-forfeitable, usually on retirement, the distinction from the annuity type case becomes only one of who is committed to make the future payments. While such a distinction might affect the valuation of the promise to pay, the incidence of tax, if the economic benefit theory is right, would have become fixed. In order to avoid this result, many arrangements provide for post-retirement conditions.<sup>39</sup> These can, of course, not be substantial and seldom are; otherwise the employee would just not buy the deferral. Whether or not the government could persuade a court to disregard nominal conditions to tax the value of a right for which no further full-time service was to be rendered is a subject where the educated guess is even less reliable than usual in this field.

Some arrangements are designed with the hope that tax will be forestalled because the future amounts to be paid the employee are not fixed

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36. *Ward v. Commissioner*, 159 F.2d 502 (2d Cir. 1947); *Oberwinder v. Commissioner*, 147 F.2d 255 (8th Cir. 1945); *Renton K. Brodie*, 1 T.C. 275 (1942). See *Miller v. Commissioner*, 144 F.2d 287 (4th Cir. 1944) where it was held that amounts withheld from Government employees to pay for retirement annuities were taxable income because they acquire economic benefits in the future.

37. In *Frederick John Wolfe*, 8 T.C. 689 (1947), *aff'd* 170 F.2d 73 (9th Cir. 1948), the fact that a corporate obligation to pay was involved was held to distinguish the case from the single premium annuity cases. *But see note*, 60 *YALE L.J.* 169 (1951).

38. *James D. Mooney*, 9 T.C. 713 (1947). The fact that the condition which would deprive the employee of the deferred compensation may be brought about only by his own act or refusal to act should not be significant. *Schaefer v. Bowers*, 50 F.2d 689 (2d Cir. 1931); *Julian Robertson*, 6 T. C. 1060 (1946); *U. S. Steel Corp.*, 2 T.C. 430 (1943).

39. Such conditions may include: The renditions of consulting services, *General Smelting Co.*, 4 T.C. 313 (1944); agreement not to engage in a competing business, *Carboloy Co.*, 2 T.C.M. 414 (1943). See *Lourie and Cutler, Deferral Compensation Agreements*, 25 *TAXES* 1077 (1947); *Tannenwald, Retirement Income Under Non-Qualified Plans: Insurance and Annuities*, N.Y.U. 12TH INST. ON FED. TAX 351 (1954).

but are dependent on earnings or dividends of the employer in the years when payment is due. This hope is derived from several cases which have held that where the value of speculative stock, which was restricted as to resale, was not ascertainable with reasonable certainty no tax would be applied.<sup>40</sup> However, close examination of the facts in the cases where this broad principle was applied indicates that there was considerable doubt whether the stock had any value at all. To rely on these cases alone to prevent tax would ignore the real possibility that either Congress or the courts will act to prevent avoidance of tax simply because of a difficulty in determining value where amounts paid as compensation are of admitted value.

## II. QUALIFIED RETIREMENT AND PROFIT-SHARING PLANS

Possibly the most convincing evidence of the impact of tax considerations on compensation arrangements is found in the design of retirement plans which have been adopted since 1942 when the Internal Revenue Code was amended to provide for qualified pension, profit-sharing and stock bonus plans.<sup>41</sup> Almost every industry pension plan has been tailored to meet the requirements of the tax law so that the employer will obtain a tax deduction at the time of contribution under a qualified plan.<sup>42</sup> The employee is not taxed prior to the time amounts are made available to him<sup>43</sup> and the trust set up under funded plans is exempt from income taxation.<sup>44</sup> The most prominent feature of such plans is the requirement that they not discriminate in benefits or contributions in favor of supervisory or highly compensated employees. This was to give effect to the intent of Congress in passing the law which was to encourage adoption of pension plans benefitting large groups of employees.<sup>45</sup>

More recently the advantages of qualified plans have been increased

40. The principle case cited in support of this theory is *Helvering v. Tex-Penn Oil Co.*, 300 U.S. 481 (1937) which dealt with the valuation of highly speculative stock which was restricted as to resale. See discussion in *MAGILL, op. cit. supra* note 24 at 125-127; *Lyons, Capital Gains Benefits Connected with Executive Retirement*, N.Y.U. 12TH INST. ON FED. TAX 365, 385 (1954).

41. Prior to 1942, the law had allowed the deduction of contributions to a pension trust for amounts which were attributable to pension liability accruing during the year, plus not more than 10% of additional amounts. INT. REV. CODE OF 1939, § 23 (p). And see § 165 of the original code which exempted a stock bonus, pension or profit-sharing trust for the exclusive benefit of "some or all employees" from the tax imposed on trust income. See *Bomar, Requirements for Qualification of Plans*, N.Y.U. 13TH INST. ON FED. TAX 395 (1955); *Lindquist, Pension and Profit-Sharing Plans Under the Internal Revenue Code of 1954*, 33 TAXES 30 (1955).

42. INT. REV. CODE OF 1954, § 404. See *Gordon, Discrimination Problems in the Drafting and in the Operation of Pension and Profit-Sharing Plans*, N.Y.U. 14TH INST. ON FED. TAX 1153 (1956). *Block, Deductibility of Employer Contributions to Qualified Pension and Profit-Sharing Plans*, N.Y.U. 13TH INST. ON FED. TAX 409 (1955).

43. INT. REV. CODE OF 1954 § 402. For recent rulings setting out principles for determining when amounts are made available to employees see *Rev. Rul. 55-423*, 1955-1 CUM. BULL. 41; *Rev. Rul. 55-424*, 1955-1 CUM. BULL. 42; *Rev. Rul. 55-425*, 1955-1 CUM. BULL. 43. 44. INT. REV. CODE § 501.

45. H.R. REP. No. 2333, 77th Cong., 2d Sess. 103 (1942).

to allow capital gains treatment of lump sum distributions to participants.<sup>46</sup> This innovation has resulted in provision for lump sum distributions by qualified pension trusts of all of an employee's credits in one year, though retirement programs are ordinarily intended to provide lifetime benefits. A more frequent use of the provision has been in qualified profit-sharing and stock bonus plans which have been adopted or amended recently. The tremendous increased popularity of employee investment or thrift plans is believed to be directly attributable to all the advantages to be gained from qualified trusts.<sup>47</sup>

The policies of the Treasury Department are of vital concern to the administration of these tax provisions with regard to qualified plans. To date the Treasury has seemed to lean toward a most liberal construction of the law insofar as a determination of the types of plans which may qualify. For example, if a plan simply provides that all employer contributions are to be made from earnings and profits, the plan will qualify as a profit-sharing plan even though its true purpose may be to provide for welfare benefits.<sup>48</sup> On the other hand, the government's position with regard to any aspect of discrimination in benefits is often much more strict than judicial opinion, which may have been expressed, would seem to allow.<sup>49</sup>

Nevertheless, any compensation plan which can be effected through the use of a qualified plan will afford benefits to employees and employers alike which cannot be matched in any other way. First, the tax consequences are predictable. The possibility that the attractiveness of a plan will be nullified in the future by some unique Treasury position or unusual court opinion is considerably lessened because advance rulings on the qualification of plans can be obtained on application to the Internal Revenue Service.<sup>50</sup> Secondly, employees can realize compensation at capital gains rates. There is no other way that this may be accomplished.

Several recent rulings of the Internal Revenue Service dealing with qualified plans should be noted. The Commissioner now holds that a

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46. INT. REV. CODE 1954, § 402(a)(2). If all of an employee's share from a trust is paid in one taxable year because of death or other separation from the employer's service, the amount is taxable as a long-term capital gain. See Rev. Rul. 56-214, 1956 INT. REV. BULL. No. 20, at 12.

47. See General Motors Savings-Stock Purchase Program For Salaried Employees in the United States (1955); Ford Motor Company Savings and Investment Program (1956); Employee Savings Plan, Socony Vacuum Oil Company, Inc. (1953); The duPont Thrift Plan (1955); Hercules Powder Company Employee Savings Plan (1956); General Foods Employee Savings Investment Plan (1953). The texts of the plans referred to can be found in the reports on proxy statements of the respective companies, which are on file for public inspection in the Securities and Exchange Commission.

48. See Special Ruling, CCH PENSION PLAN GUIDE par. 16080 (1955) dealing with trusts set up to provide unemployment benefits.

49. Compare I.T. 4020, 1950-2 CUM. BULL. 61 with Volckenning, Inc., 13 T.C. 723 (1949).

50. For a consideration of the effect to be given a ruling of the Commissioner and its later revocation, see *Dejay Stores, Inc. v. Ryan*, 229 F.2d 867 (2d Cir. 1956).

profit-sharing arrangement may qualify under section 401(a) as a profit-sharing plan if it provides that an employee may elect (1) to take his distributive share of the current year's profits in cash, (2) to defer it to a future year, or (3) to take part of it in cash and defer part.<sup>51</sup> Examples are provided of the operation of two plans during a specific year with comment on qualification. In determining whether a plan is non-discriminatory, reference is made only to the employees who elect to participate in the deferred payment trust. This means that there must be sufficient participation each year in the deferral arrangement by the lower paid employees if a plan is to be held not discriminatory in practice in favor of the higher paid employees.

Another ruling of considerable interest indicates that the Commissioner will now approve a type of plan which the courts had previously upheld as qualified contrary to his contention. It is indicated that a profit-sharing or stock bonus plan will be considered to qualify under the 1939 Code even though it does not provide for a definite predetermined formula for determining the profits to be shared.<sup>52</sup>

The Commissioner has also ruled that a profit-sharing trust will be considered a valid existing trust even though at the end of a particular year its only corpus is the promise of the employer to make a contribution.<sup>53</sup> In the case considered, the promise to pay was deemed sufficient where the employer had executed a trust agreement under seal as a part of its profit-sharing plan, and, under local law, a promise under seal was binding without other consideration.

A ruling of questionable validity provides that a stock bonus, pension, or profit-sharing plan will not qualify under Section 401(a) if the employee has the right to elect to have all or part of his non-forfeitable interest, which would otherwise become available to him during his lifetime, paid to his beneficiary after death.<sup>53(a)</sup> Reliance is placed solely on an interpretation of a regulatory requirement that funds be distributed to an employee. The joint and survivor annuity contract is distinguished on the ground that there the payment to another is only incidental.

Nor can a qualified pension plan permit participants to withdraw, prior to severance of employment or termination of the plan, all or part of funds accumulated on their behalf, in times of need or otherwise.<sup>53(b)</sup> This is held to be inconsistent with the accepted concept of a pension plan but not necessarily of a profit-sharing plan. Qualified pension plans may provide

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51. Rev. Rul. 56-497, 1956 INT. REV. BULL. No. 41, at 68.

52. Rev. Rul. 56-366, 1956 INT. REV. BULL. No. 31, at 26. *Commissioner v. Produce Reporter Co.*, 207 F.2d 586 (7th Cir. 1953). The final regulations under the 1954 Code specifically eliminate the need for a pre-determined formula. U.S. Treas. Reg. § 1.401-1(b)(2) (1952).

53. Rev. Rul. 55-640, 1955-2 CUM. BULL. 231.

53(a). Rev. Rul. 56-656, Int. Rev. Bull. No. 51 at 13.

53(b). Rev. Rul. 56-693, Int. Rev. Bull. No. 52 at —.

for disability or death benefits which are only incidental to the main purpose of the plan.

A court holding of some significance to corporations which maintain both a pension and a profit-sharing or stock bonus trust should be kept in mind. Even though the law provides for a limitation of 25% of other compensation on contributions to two trusts,<sup>54</sup> the actuarial cost limitation for the pension trust contribution and the 15% of compensation limitation for the other trust must be met successively where the same employees are beneficiaries of both trusts.<sup>55</sup>

A little publicized provision of the 1954 Code added a further incentive to the establishment of qualified plans. The value of payments receivable by any beneficiary (other than the executor) from an employee's trust established under a plan which was qualified at the time of the decedent's separation from employment, or at the time of termination of the plan, if earlier, is excludible from gross estate for federal estate tax purposes. The exclusion is not allowable to the extent such payments are attributable to the decedent's own contributions. The exclusion applied only in the case of decedent's dying after December 31, 1953.<sup>56</sup>

### III. DISABILITY PLANS

One of the principal changes in the 1954 Code deals with the taxation of disability benefits paid directly by an employer. Prior to 1954, amounts which were received as accident and health insurance were fully exempt from tax.<sup>57</sup> The courts had, and are still having, considerable trouble in deciding whether amounts paid directly by an employer constitute "insurance." The law now provides specifically that amounts paid under all employer financed wage continuation plans are exempt from tax up to \$100 per week.<sup>58</sup>

The Treasury Regulations interpreting section 105 are liberal but confusing in several respects. As originally promulgated, they provided that only amounts which were attributable to a temporary period of absence were excludible.<sup>59</sup> Further, payments to retired employees were held not to be wages or payments in lieu of wages so as to qualify for the exemption. However, after considerable criticism by industry and insurance representatives, the final regulations amended these provisions to provide that a plan under which benefits are continued until the employee is either able

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54. INT. REV. CODE OF 1954, § 404(a)(7).

55. *Parker Pen Co. v. Kuhl*, 234 F.2d 607 (7th Cir. 1956).

56. INT. REV. CODE OF 1954, § 2039(c). The committee reports do not indicate why the exclusion does not apply to amounts payable to the estate of the employee.

57. INT. REV. CODE OF 1939, § 22(b)(5).

58. INT. REV. CODE OF 1954, § 105. See generally Pyle, *Accident and Sickness Insurance Under Code Sections 104, 105, 106 and 213*, 34 TAXES 363 (1956). Comment, *Taxation of Employee Accident and Health Plans Before and Under the 1954 Code*, 64 YALE L.J. 222 (1954).

59. Notice of Proposed Rule Making, 20 Fed. Reg. 1781, § 1.105-4(a) (1955).

to return to work or reaches retirement age may constitute a wage continuation plan.<sup>60</sup> This clearly eliminates the temporary period of absence test. Further, the exclusion will be applicable to payments made under a plan which provides that an employee will receive a disability pension as long as he is disabled, except that it will not apply to payments received after he reaches retirement age. This would seem to be a contradiction in terms to some extent, since pensions are only paid to retired employees, and retirement age would normally be thought to refer to the year in which the employee retired. "Retirement age," as used in the regulations, must refer, and in the context it is used, can only logically refer, to the age at which the employee would have retired except for the disability. This can, of course, mean either the compulsory or the voluntary retirement age under the plan. If Internal Revenue takes the position that the reference to retirement age is the earliest age at which the employee could have voluntarily retired, then it is doubtful whether the regulations would permit an exemption for amounts paid even to active employees who are eligible to retire. This could not have been intended, but a literal reading of the regulations might require that result.

It is submitted that the regulations have expanded the scope of section 105 beyond the original intent of Congress though it is admittedly difficult to determine with any degree of assurance what that intent was.<sup>61</sup> Certainly pension plans of any form are not ordinarily thought of as wage continuation plans for employees. Indeed, pensions are paid only to retired employees. However, the whole scheme of section 105 is difficult to justify. The practical problems which it creates for employers may soon be of major importance. For the tax law now places a premium on absence from work. No employee is going to be in a hurry to give up the weekly exemption, especially if there is any possibility of a relapse which, under the regulations, would require another waiting period before the exemption is applicable again. Most employers just cannot police employee's activities to prevent malingering.

Remedial legislation is certainly indicated in the field of taxation of disability pay or accident and health insurance, or whatever it may be called. It is difficult to rationalize the disallowance of deduction of incurred medical expenses, and, at the same time, exempt income received while disabled. Removal of the limitation on the medical expense deduction or a new exemption for medical expense reimbursements would seem to be a much sounder theoretical approach, and would, at the same time, remove

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60. U.S. Treas. Reg. § 1-105-4(a)(2)(i) (1954).

61. The Senate apparently was concerned principally with equalizing the tax treatment of benefits paid under a contract of insurance and those paid directly by employers. S. REP. 1622, 83d Cong., 2d Sess. 15-16 (1954). While this report contains a reference to "accident or health benefits under employer pension plans," there is no other indication that the plain language of § 105, which refers only to wage continuation plans for employees, was meant to include former employees or pensioners.

from the employer the responsibility for the accurate computation of his employee's taxes which he must now assume. If the employer adjusts withholding tax on employees' current compensation to insure that they will obtain the benefit of the exclusion, the amount of the correct exclusion must appear on the withholding statement and the responsibility for its accuracy is the employer's.<sup>62</sup> If withholding is not adjusted, records must still be maintained as a matter of employee relations in order that employees will have the information to put on their tax returns.

Interpretations of the word "insurance" under prior laws are still of current interest. The courts are pretty evenly divided in holdings that direct disability payments by employers are insurance.<sup>63</sup> The courts which hold they are not apparently would require the issuance of a formal insurance policy. There is no case which even questions the popular arrangement of many formal industry insurance plans whereby the insurance company simply allows the employer to draw on its drafts and charges a percentage fee based on the amounts paid out each year by the employer. Such plans, of course, do not involve the assumption of risk by the insurance company, and yet payments made under such plans would be held to be insurance for purposes of the exemption without question. The reasoning of the courts which have held that direct disability payments made by employers under established employee plans are, in substance, insurance is difficult to criticize. The employees are, for all practical purposes, insured under such plans, and the true risk of disability is assumed by the employer. Surely allowance of the exemption was never meant to depend on the execution of a formal insurance contract without regard to the nature of the risks assumed by the insurer.

#### IV. DEATH BENEFIT PAYMENTS

Corporate payments to survivors of employees have recently been the subject of much litigation. Taxpayers generally have argued that since no services were rendered by the recipient, the payment constituted a non-taxable gift even though the payor may have deducted the amount as compensation paid. The Tax Court has ruled in a number of cases that payments made directly to widows are gifts where there was no legally enforceable obligation to make the payment.<sup>64</sup> The court has indicated

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62. U.S. Treas. Reg. § 31.6051-1 (1954).

63. For cases holding that direct employer disability payments are insurance see *Epmeier v. United States*, 199 F.2d 508 (7th Cir. 1952); *Pfleiderer v. United States*, \_\_\_ F. Supp. \_\_\_ (D.C. Ind. 1956); *Adams v. Pitts*, 140 F. Supp. 618 (D.C. S.C. 1956); *contra*, *United States v. Haynes*, 233 F.2d 413 (5th Cir. 1956); *Hanna v. United States*, \_\_\_ F. Supp. \_\_\_ (D.C. Tex. 1956); *Townsend v. United States*, 143 F. Supp. 150 (D.C. Ill. 1956); *Cary v. United States*, 141 F. Supp. 750 (D.C. Neb. 1956); *Harbkersman v. United States*, 133 F. Supp. 495 (D.C. Ohio 1955).

64. *Elizabeth R. Mathews*, 15 CCH Tax Ct. Mem. Dec. 204 (1956); *Louise K. Aprill*, 13 T.C. 707 (1949); *Alice M. MacFarlane*, 19 T.C. 9 (1952); *Est. of Arther W. Hellstrom*, 24 T.C. 916 (1955). And see *Slater v. Riddell*, F. Supp., (D.C. Cal. 1956).



that a different result might be reached if the payment had been made to the estate.<sup>65</sup> There has been no apparent consideration in these cases of the possibility that the amount paid was taxable because it was income in respect of a decedent under the law.<sup>66</sup>

On the corporate deduction side, the Tax Court has applied strict standards. Where it was shown that the payment was made solely because of the poor circumstances in which a widow was left, deduction was disallowed.<sup>67</sup> Thus, while it is felt to be of little significance in the beneficiaries' income cases that the payer deducted the amounts paid as compensation, it is not unreasonable to assume that Internal Revenue may attempt to deny a deduction to the payor in any case where the payment has been held to be a gift to the beneficiary.

In 1951 Congress provided that amounts paid under a contract with an employer providing for payment to the employee's beneficiary on his death would be excludible from gross income to the extent of \$5000 from each employer.<sup>68</sup> The 1954 Code eliminated the requirement that the payment be contractual and extended the exclusion to any amounts which are paid by reason of the death of an employee. The exclusion does not apply to amounts which are non-forfeitable to the employee unless such amounts are payable in a lump sum from a qualified trust. The maximum amount receivable tax-free is fixed at \$5,000 for any one employee regardless of the number of employers who may make payments.<sup>69</sup>

#### V. MOVING EXPENSE REIMBURSEMENTS

Prior to the issuance of two recent rulings, the Internal Revenue Service and the courts had consistently held that all employer reimbursements for moving expenses were taxable income and that the expenses were not deductible by the employees.<sup>70</sup> Late in 1954 the Commissioner published a ruling which provides that the reimbursement for the cost of moving an employee, his immediate family and his personal effects from

65. See *Est. of Arthur W. Hellstrom*, 24 T.C. 916, 920 (1955).

66. *Est. of Edgar V. O'Daniel v. Commissioner*, 173 F.2d 966 (2d Cir. 1949); *Est. of Edward Bausch v. Commissioner*, 186 F.2d 313 (2d Cir. 1951).

67. *W.D. Haden Co.*, 5 CCH Ct. Mem. 250 (1946); *McLaughlin Gornley King Co.*, 11 T.C. 569 (1948).

68. INT. REV. CODE OF 1939, § 22(b)(1)(B).

69. INT. REV. CODE OF 1954, § 101(b). It has been suggested that because of the specific statutory exclusion for death benefit payments, the courts may be inclined to more closely examine the gift theory where payments are made to employees' survivors. *Yohlin, Employer Payments to the Widow of a Deceased Employee*, 34 TAXES 87 (1956). And see *Mickey and Hill, Income Tax Consequences of Payments to Employee's Widow and Relatives*, N.Y.U. 12 Ann. Inst. 409 (1954).

70. See *Forest W. Rice*, 13 CCH Tax Ct. Mem. 394 (1954); *John Lee York v. Commissioner*, 160 F.2d 385 (D.C. Cir. 1947). Cf. *Otto S. Schairer*, 9 T.C. 549 (1947) where it was held that amounts paid by an employer to reimburse him for the loss suffered on sale of a residence by a transferred employee were part of the amount realized from the sale, and, as such, were not taxable compensation. However, amounts paid to a transferred employee to assist him in buying a house are taxable. *Rinehart*, 18 T.C. 672 (1922).

one place of employment to another permanent place of employment, primarily for the benefit of the employer, is not compensatory in nature, and is not taxable except to the extent the reimbursement exceeds actual moving expenses incurred. However, amounts received as reimbursements for meals and lodging of the employee and his family while awaiting permanent quarters at the new post of duty do not constitute moving expenses and are fully taxable.<sup>71</sup> A subsequent ruling provides that all reimbursements for the expense of moving an employee's family to a "locality where he has accepted new employment with another employer will be includible" in taxable income of the employee.<sup>72</sup>

While the first ruling represents a liberalization of former Internal Revenue policy and the second simply continues past policy, their practical effect will probably be that employees who previously escaped tax on moving expenses reimbursements will now be required to pay tax on the portion of reimbursements which are taxable. This is because employers generally did not withhold tax on any moving expense reimbursements because the Internal Revenue Service had issued no rulings distinguishing reimbursements for transfer expenses from travel reimbursements on which no withholding was required under the regulations. This did not mean, of course, that the employees should not have included such reimbursements in gross income, but it is probable that the great majority did not. After issuance of these two rulings, withholding will be required on amounts which are now held to constitute taxable income.

These two rulings will undoubtedly cause considerable confusion because they do not contain adequate guides for interpretation. For example, a number of problems can be encountered simply in trying to set down a rule as to when a transferred family stops "moving" and starts "awaiting permanent quarters." If a new residence is ready, but the employee's furniture has not arrived, so that the family must live in a hotel for a period of time, is the reimbursement for expense incurred taxable or not taxable under the ruling? Obviously there will be little uniformity in taxation of such reimbursements if problems like these must be resolved by the person in charge of withholding procedure for each individual employer.

#### CONCLUSION

This high spot account of current compensation problems with which industry tax counsel are faced daily does not consider many of the aspects that are always involved in any payment of compensation. A comprehensive discussion of each of the subtopics covered could constitute an article by itself. It should appear, however, that tax advisers to industry cannot confine their expertness to perfection of the tax return of a particular

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71. Rev. Rul. 59-429, 1954-2 CUM. BULL. 53.

72. Rev. Rul. 55-140, 1955-1 CUM. BULL. 317.

business. Tax matters are no longer of concern only to the financial officers. In considering methods of paying compensation, employee relations personnel must work closely with the tax adviser because of the importance of the tax consequences.

The necessity for accurate withholding has been responsible for this to some extent since any deduction from an employee's pay check must be carefully explained. Obviously, the closer concern of industry managers for employee's problems has had some effect. If a company can save its employees tax dollars, much good will is created. However, it is probably the increasing complexity of the tax laws which has primarily served to make the employees' problems with regard to tax on compensation those of his employer. Individual employees just do not have the facilities available to keep up with the advantages or requirements of the law which may pertain to them. For instance, how many disability retired employees would be expected to know that after January 1, 1954, their pensions were exempt from tax up to \$100 per week. Active employees cannot anticipate how a plan may affect them individually, and no employer can afford to have his employees get the first bad word about a plan from the tax collector. While various publications do an excellent job of reporting tax matters, most employees do not have regular access to them, and must look to the employer to keep them advised. Since the tax laws seem to become increasingly difficult to simplify, it can be expected that this responsibility will increase. Undoubtedly the scramble to devise compensation plans which take advantage of every feature of the tax law will continue.

However, in attempting to improve the tax picture of the employee, the industry tax adviser may often be faced with a situation where the risk of additional cost to the employer is increased. For instance, deferred compensation arrangements can prove to be very costly to an employer if they are designed to benefit the employee fully. The tax deduction of such amounts must be deferred to the year of actual payment. This may result in its effective loss if there is not sufficient income to offset in the later year. Making the amounts of such compensation dependent on future earnings or dividends may result in their being unreasonable in amount, and so not deductible. Of course, against these factors must be weighed the possibility that the current use of deferred amounts in the business will prove to be of benefit financially in years when money for expansion is scarce.

While the employer deduction problem is associated ordinarily with the industry tax adviser, the individual income tax problem of employees has not been. The tax consequences attributable to new and unique methods of paying compensation are causing a vast change in the emphasis which must now be placed on the resulting tax to employees.