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Taxation of Non-Qualified Deferred Compensation Plans

By RICHARD S. WEINBERG*

John Q. Executive has just been informed that he will receive a promotion and pay raise of 10,000 dollars per year. Of course, he is very happy; however, his elation is somewhat diminished when he realizes that the government will take a large portion of his pay raise for income taxes. He wonders whether there is some way to preserve more of this money for himself and his family; and soon he is listening to an explanation of the benefits to be derived from the use of a deferred compensation contract to postpone recognition of income until after he has retired.

After retirement, he will have less income from other sources so that payments received at that time will be taxed at a lower rate. Similar tax advantages are available under qualified pension plans. However, a qualified plan may not be available; and even if one is available, a deferred compensation contract may be used to supplement its benefits.

This article will deal only with deferred compensation contracts which do not qualify as pension plans and will briefly sum up the income tax consequences of such contracts. It will deal at length with the gift and estate tax consequences of such contracts and the income taxation of beneficiaries in case the employee dies before payments under the contract have been completed.

Income Taxation of the Employee and the Employer's Deduction

Under Section 61 of the Internal Revenue Code of 1954, "gross income means all income from whatever source derived, including . . . compensation for services . . ." There can be no dispute that payments under a deferred compensation contract must be included in gross income. The vital question has been whether taxation can be postponed until payment is actually received.

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In 1960, the Internal Revenue Service, by its acquiescence in *Oates v. Commissioner*,[1] and publication of Revenue Ruling 60-31,[2] sanctioned postponement of taxation until the employee received payments under a deferred compensation contract provided that the "Constructive Receipt" doctrine does not apply to the arrangement and that the arrangement is not funded.

The "Constructive Receipt" doctrine is based upon the rule that "income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not."[3] It would apply if John Q. Executive was handed his salary raise by his employer and then said "No, you hold this money for me until next year." In such a case, the income must be reported in the year in which payment was originally tendered. "A taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it."[4] In order to avoid application of this doctrine, a deferred compensation arrangement must be entered into before the employee has an immediate right to demand payment for services rendered.[5]

Funding the employer's obligation by establishing a trust or purchasing an annuity must also be avoided. As soon as funding occurs, the employee must recognize income even though he has no right to sell or assign his interest, unless the arrangement contains substantial contingencies which could cause the employee to forfeit his interest.[6] Even though it contains contingencies to postpone the employee's recognition of income, a funded plan is not a satisfactory arrangement because the employer will probably be denied a deduction for contributions made under such an arrangement.

Section 404(a)(5) of the Internal Revenue Code of 1954,

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[1] 207 F.2d 711 (7th Cir. 1953).

[2] 1960-1 Cum. Bull. 174.

[3] Corliss v. Bowers, 281 U.S. 376, 378 (1930).

[4] Rev.-Rul. 60-31, 1960-1 Cum. Bull. 174, 178; citing Hamilton Nat. Bank of Chattanooga, Administrator, 29 B.T.A. 63, 67 (1933).

[5] Although the cases indicate that deferral can be made even after the services have been rendered (Howard Veit, 8 T. C. 809 (1947); Oates v. Commissioner, *supra* note 1), a careful practioner could be expected to negotiate the deferred compensation arrangement before the services have been rendered whenever possible.

[6] Int. Rev. Code of 1954, § 402(b) and § 403(c); see Renton K. Brodie, 1 T.C. 275 (1942); Hackett v. Commissioner, 159 F.2d 121 (1st Cir. 1946); United States v. Drescher 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950).

which governs the employer's deduction, provides that the deduction will be allowed "in a taxable year when paid, if the plan is not (a qualified plan), if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid." According to the Regulations interpreting this section, "if an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year."[7] Thus, it appears that the only type of deferred compensation arrangement which will effectively postpone recognition of income on the part of the employee and at the same time allow the employer a deduction, is one which does not provide for funding. Even if an unfunded arrangement contains contingencies, the employer will get a deduction under Section 404(a)(5) because the employee's rights are nonforfeitable at the moment of payment.

Gift Tax Consequences

If John decides to have payments under a deferred compensation arrangement continue after his death and to name a beneficiary, it is necessary to examine the question of whether a gift for gift tax purposes has been made. If such a gift has been made, it will be necessary to file a gift tax return. (This would be a gift of a future interest for which no annual exclusion is allowed.)[8]

The Internal Revenue Code provides that the gift tax is imposed on "the *transfer* of *property* by gift . . .[9] whether the gift is direct or indirect and whether the property is . . . tangible or intangible."[10] (Emphasis added.) The value of the gift is the *value* of the property at the date of the gift.[11] These provisions

First, there must be a "transfer." If John Q. Executive reserves the right to change or revoke his designation of a beneficiary, contain two important concepts.

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[7] Treas. Reg. Sec. 1.404 (a)-12; but *cf.* Russell Mfg. Co. v. United States, 175 F. Supp. 159 (Ct. of Claims 1959).

[8] Int. Rev. Code of 1954, § 2503(b); Roberts v. Commissioner, 143 F.2d 657 (5th Cir. 1944), *cert. denied,* 324 U.S. 841 (1945).

[9] *Id.,* § 2501(a).

[10] *Id.,* § 2511(a).

[11] *Id.,* § 2512(a).

then, clearly, there has been no transfer because there has been no abandonment of control over the property[12] and no gift. On the other hand, if the designation of a beneficiary is irrevocable, this should be considered a "transfer" within the meaning of the gift tax provisions.

Under a funded arrangement which is nonforfeitable, the Regulations specifically state that the irrevocable designation of a beneficiary is a taxable transfer.[13] If the funded arrangement is forfeitable, there may be some questions as to whether a "transfer" has taken place because the employee can defeat the rights of the beneficiary by refusing to perform one of the conditions precedent to payment. However, this should also be considered a transfer because although the employee can defeat the beneficiary's rights, he cannot recover the interest for himself. This is like saying that when *A* gives a house to *B*, there has been no transfer because *A* can burn down the house.[14] It would also appear to follow that the irrevocable designation of a beneficiary under an unfunded contract constitutes a transfer.[15]

Second, there must be "property" and there must be "value." There are two ways of considering these elements. One might say that an extremely remote and speculative interest is property but has no value, or that it has no value and, therefore, is not property but merely an expectancy. Although this appears to be only a question of semantics, it may be the determining factor. In the gift tax area, the construction of the sections of the Code suggest that the determination of whether or not there is property should be made first, and then the question of value should be decided.

In considering these questions it is important to avoid applying the rules set forth for income taxation. The only problem under the income tax provisions is when the recipient should be taxed, whereas under the gift and estate tax provisions, the problem is whether the transferor will be taxed at all. For this reason, "there

12 Smith v. Shaughnessy, 318 U.S. 176, 181 (1943); Treas. Reg., § 25.2511-2(b)&(c).

13 Treas. Reg., Sec. 25.2511-1(h)(10); *cf.*, Rev. Rul. 58-307, 1958 -1 Cum. Bull. 206. § 2517 of the 1954 Code excludes certain gifts of interests under a qualified plan from taxation.

14 Lowndes and Kramer, Federal Estate and Gift Taxes 656 (1956); *cf.* Est. of Edward H. Wadewitz, 39 T.C. 925, 937 (1963).

15 *But cf.*, Higg's Estate v. Commissioner, 184 F.2d 427 (3d Cir. 1950) discussed *suppra.*

is no relationship between the gift and income tax and neither is dependent on the other as a basis for imposition of a tax."[16]

When the general gift tax provisions were originally enacted as a part of the Revenue Act of 1932, the purpose was to reach all inter vivos transfers which might diminish the assets of the transferor's estate; and the committee reports said that the terms of these sections should be construed "in the broadest and most comprehensive sense . . . reaching every species of right or interest protected by law and having an exchangeable value."[17] The Supreme Court has said:

> Even though these concepts of property and value may be slippery and elusive, they cannot escape taxation so long as they are used in the world of business . . . The language of the gift tax statute . . . is broad enough to include property however conceptual or contingent.[18]

The purport of these general statements is that any interest, which has any value at all, is property within the meaning of Section 2501(a) of the Internal Revenue Code of 1954.

Although there are no gift tax cases dealing directly with deferred compensation arrangement, three cases warrant consideration.

In *Continental Illinois Bank, Executor (for Estate of Aver)*,[19] property was delivered to the University of Chicago and to Newberry Library as charitable gifts. These organizations promised to pay 6,000 dollars per year to the donor for the rest of his life and then to continue the 6,000 dollars per year payments to his wife and daughter. The Board of Tax Appeals held that a gift had been given to the wife and to the daughter. The interest involved was treated as though it was a commercial annuity even though the obligor was not an insurance company.

In *Cerf. v. Commissioner*,[20] renewal commissions on life insurance policies which would be earned in the future were assigned to a trust which benefitted the assignor's wife. The third

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[16] Galt v. Commissioner, 216 F.2d 41, 45 (7th Cir. 1954), *cert. denied*, 348 U.S. 951 (1955).

[17] H.R. Rep. #708, 72d Cong. 1st Sess., 27 (1932); Sen Rep. #665, 72d Cong. 1st Sess., 39 (1932).

[18] Smith v. Shaughnessy, *supra* note 12, at 180.

[19] 29 B.T.A. 945 (1934).

[20] 141 F.2d 564 (3d Cir. 1944); Compare Oates v. Commissioner, *supra* note 1.

circuit held that there was a gift at the time of assignment even though the trust's interest depended upon the number of renewals and the solvency of the employer.

In *Galt v. Commissioner*,[21] a lease to racetrack property was assigned without consideration. The rental under this lease was a percentage of the parimutuel betting at the racetrack. The seventh circuit held that a gift had been made on the date of assignment. "It is true," the court said, "that the value of the gift as represented by the assignment . . . was speculative, uncertain and contingent upon future developments. . . . Even so this is an immaterial factor in determining whether a gift was made at that time."[22]

Even if it is decided that the interest under a deferred compensation arrangement is "property" it might be argued that the gift of an interest under a contingent arrangement or one which depends upon the continuing solvency of the employer has no present value because one of the conditions precedent might not be performed or the employer might become insolvent. However, in *Robinette v. Helvering*,[23] the Supreme Court ruled that the value of the interest is to be computed actuarially, as though there were no contingencies other than survival involved. Then the donor must demonstrate the value which the contingencies subtract from the gift. If he cannot do this, there is no reduction in value. In the case of contingencies, such as continued service, covenants not to compete, rendition of consulting services, or continued solvency, the employee would have great difficulty in fulfilling his burden of proof and the full value would be, in most cases, taxable.

Estate Taxation

While the discussion of gift taxation has been hypothetical because of the paucity of cases, there are many estate tax decisions. In order to understand these decisions, the 1954 Code must be examined.

Under Section 2033 of the Internal Revenue Code of 1954, "the gross estate shall include the value of all property . . . to the extent of the interest therein of the decedent at the time of his

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[21] *Supra* note 16.
[22] *Id.* at 50.
[23] 318 U.S. 184 (1943).

death." This section should apply if the interest under a deferred compensation contract passes to a beneficiary either by will or intestacy, and if that interest is "property," within the meaning of the term as used in Section 2033. However, if a beneficiary is designated during the employee's lifetime, this constitutes an inter vivos transfer of the only interest which passes at death and must be reached, if at all, under other provisions of the 1954 Code.[24]

A transfer whereby the employee gives up his rights under a deferred compensation contract would first be tested against the requirements of Section 2035 to determine whether it was made in contemplation of death. If the employee dies within three years after the irrevocable designation of a beneficiary, the presumption that this was a gift in contemplation of death[25] would have to be rebutted. If the employee lives for more than three years after making an irrevocable transfer, the transfer cannot be said to have been made in contemplation of death, regardless of the employee's motives, and in spite of the fact that the only interest transferred was an interest which will not produce any beneficial enjoyment until after death.[26]

Section 2036 (a)(1) of the 1954 code provides:

> The gross estate shall include the value of all property . . . to the extent of any interest therein of which the decedent has at any time made a transfer (by gift) under which he has retained for his life, or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—the possession or enjoyment . . . of the property. (Emphasis added.)

It is obvious that the question of whether the interest is "property" will be raised under this section as it was under Section 2033.

There is another question which may also be raised under this section. In *Higg's Estate v. Commissioner*,[27] the court held that in a situation where the employer purchased a nonforfeitable annuity policy under which a beneficiary had been irrevocably designated by the employee, there had been no "transfer" by the

[24] Estate of Edward H. Wadewitz, 39 T.C. 925, 935 (1963).
[25] Int. Rev. Code of 1954, § 2035(b).
[26] *Ibid.*
[27] 184 F.2d 427 (3d Cir. 1950).

employee, "for the annuity contract was purchased by his employer."[28] If this holding is sound, all that the employee need do to escape application of 2036(a)(1) is to enter into a deferred compensation contract which requires that the payments be made to a named beneficiary after death. However, this holding is not sound unless we say that Higg's employer made a gift to him and a second gift to his wife.

Some of the cases decided in this area have made such a finding when the payments are purely voluntary on the employer's part.[29] If such a finding is made, the employee would pay no income tax on the payments made to him and no gift or estate tax would be paid on payments to his beneficiary. In *Commissioner v. Duberstein,*[30] the Supreme Court held that the question of whether payments by an employer were gifts or compensation for services, was one of fact to be decided on the basis of human experience and the multiplicity of relevant factors.

Even when there is no contractual obligation to make such payments, a court could find that the payments were made as compensation for services rendered or to be rendered by the employee.[31] In such a case or in a case where the employer is contractually obligated to make such payments, the courts should hold that a "transfer" has been made by the employee both for gift tax purposes and for application of the transfer provisions of the estate tax. As Mr. Justice Stone has said:

> Obviously the word "transfer" in the statute, or the privilege which may constitutionally be taxed, cannot be taken in such a restricted sense as to refer only to the passing of particular items of property directly from the decedent to the transferee.

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[28] *Id.* at 431.

[29] Estate of William E. Barr, 40 T.C. 227 (1963); Worthen v. United States, 192 F. Supp. 727, 734 (D.C. Mass. 1961); Hanner v. Glenn, 212 F.2d 483 (6th Cir. 1954); Estate of Eugene F. Saxton, 12 T.C. 569(1949); Estate of Emil A. Stake, 11 T.C. 817 (1948).

[30] 363 U.S. 278 (1960).

[31] Rosenberg v. United States, 309 F.2d 724 (7th Cir. 1962); see Simpson v. United States, 261 F.2d 497 (7th Cir. 1958); Garber's Estate v. Commissioner, 271 F.2d 97 (3d Cir. 1959). In Estate of Albert A. Salt, 17 T.C. 92 (1951) the court found a purely voluntary plan even though no beneficiary had been denied payment for 15 years. The court based its decision on the fact that the pension board had discretion so that it could deny payment. Such a decision ignores the fact that a program of this type is designed to produce continued faithful service by the employee during his lifetime. Sutro v. United States, 42-2 U.S. T.C. 10, 215 (D.C. N.D. Cal. 1942).

> It must, we think, at least include the transfer of property procured through expenditure by the decedent with the purpose, effected at his death, of having it pass to another.[32]

As we have seen, Section 2036(a)(1) will reach the situation in which deferred benefits are paid to the employee during his life and then to a beneficiary at his death, provided that there has been a "transfer," and if the interest transferred is "property." If deferred benefits are not paid to the employee during his life, that Section will not apply. However, in such a situation Section 2036(a)(2) or Section 2038 may apply. These sections reach transfers of property made by the decedent under which he reserves the powers to alter, amend, revoke or terminate the beneficial enjoyment of the property. Under these sections the same question of whether there was a "transfer" by the decedent and whether the interest transferred was "property" are presented.

Section 2039 appeared for the first time in the 1954 Code. When the House of Representatives proposed this provision, its report stated:

> It is not clear under existing law whether an annuity . . . purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contributions is includible in the decedent's gross estate.[33]

The provision which as enacted reads as follows:

> (a) The gross estate shall include the value of an annuity or *other payment* receivable by any beneficiary by reason of surviving the decedent *under any form of contract or agreement* entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if under such contract or agreement, an annuity or *other payment* was payable to the decedent or the decedent possessed the right to receive such annuity or payment either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. (Emphasis added.)
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> (b) AMOUNT INCLUDIBLE—Subsection (a) shall apply to only such part of the value . . . as is proportionate to that part of the purchase price therefor contributed by the decedent . . . any contribution by the decedent's employer or former

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[32] Chase National Bank v. United States, 278 U.S. 327, 337 (1929).
[33] H.R. Rep. #1337, 83d Cong. 2d Sess., 90 (1954).

employer . . . shall be considered to be contributed by the decedent *if made by reason of his employment.* (Emphasis added.)

(c) (Exemption for qualified plans.)[34]

This section is not a transfer section; it would apply concurrently with Section 2033 if the beneficiary is not irrevocably designated during the life of the employee. It would also apply to situations in which Section 2036(a)(1) applies. But, if the employee receives no payment or if the beneficiary's receipt or right to receive payments is not measured by his life, for a period not ascertainable without reference to his death, or for a period which in fact ends with his death, this section does not apply at all.

In the situations where it applies, this Section eliminates the use of the word "property"; but it does not eliminate the problem. What does "annuity or other payment" mean? Could "other payment" mean "other similar payment," *i.e.*, a funded contract? In fact, the bill as originally proposed by the House of Representatives, did say "other similar payment."[35] The Senate amended this clause, but the committee report is silent about the reason for the change. All that is said is that the change is designed to make it clear that this section applies, "not only to cases where an annuity is payable to a decedent, but also to contracts or agreements under which a lump sum payment was payable to the decedent or the decedent possessed the right to receive such a lump sum payment in lieu of an annuity."[36] Every example in the committee reports and the Regulations involves a funded arrangement. It would seem that the term "other payment" still leaves the question of whether an unfunded contract is includible under Section 2039.

The requirement of a "transfer" is also eliminated and the regulations state, in an example which is designed to indicate that *Higg's Estate v. Commissioner*[37] is no longer applicable, that "all rights and benefits accruing to an employee and to others by reason of the employment . . . are considered together . . . the

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[34] Int. Rev. Code of 1954, § 2039.

[35] H.R. 8300, 83d Cong. 2d Sess. Sec. 2039 (1954), as originally proposed. See H.R. Rep. #1337, 83d Cong. 2d Sess., A316 (1954).

[36] Sen. Rep. #1622, 83d Cong., 2d Sess., 470 (1954).

[37] *Supra* note 15.

scope of Section 2039(a) & (b) cannot be limited by indirection."[38] But under Section 2039(a) it is still open to a court to find that the payments were not "receivable . . . under any form of a contract or agreement"; or to find under Section 2039(b) that the employer's contributions cannot be attributed to the decedent because they were not "made by reason of his employment."[39]

In short, in the areas where most of the estate tax problems occur, *i.e.*, unfunded contracts and noncontractual arrangements, Section 2039 does not clarify the law. Of course, it does contain new phrases and the courts could regard it as a mandate to abandon the old distinctions, and to date the courts have done just that.

In *Bahen's Estate v. United States*,[40] the Court of Claims applied Section 2039 to two plans which were unfunded. The court noted that the new statute abandoned the terms "transfer" and "property" and said, "We must pay heed to the precise new form in which Congress cast its net and not become entangled in the older meshes."[41] The court indicates that the Regulations,[42] sanction inclusion of unfunded as well as funded plans. It does not read "other payments" as being limited to other funded arrangements.[43]

The problem of defining "property" for estate tax purposes is much the same as it was for gift tax purposes. The purpose of the two taxes is essentially the same, and the courts have repeatedly said that the two taxes should be read *in pari materia*. The conclusions that "property" should have the same definition under both the estate and the gift tax and should be based upon general principles such as those announced by Mr. Justice Stone in *Smith v. Shaughnessy*[44] seem inescapable.

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[38] Treas. Reg. Sec. 20.2039-1(b)(2), Example 6.

[39] See footnote 29 *supra*.

[40] 305 F.2d 827 (Ct. Cl. 1962).

[41] *Id.* at 829.

[42] Treas. Reg. 20.2039-1(b), cited at 830.

[43] It should be noted that upon reading the Regulations there is no statement that unfunded plans fall within the purview of § 2039. The Regulations carefully follow the language of the statute on this point and none of the examples deals with an unfunded plan. This case is also significant in that it approves Section 20.2039-1(b)(2) Example 6 which says that two plans may be considered together in order to invoke the application of Section 2039. See also All v. McCobb, 321 F.2d 633 (2d Cir. 1963).

[44] *Supra* note 18.

The villain in this situation may be the Commissioner himself. In 1937, a General Counsel's Memo was issued which ruled that a sum paid to a beneficiary under an employee's death benefit plan was not an interest in property but was only an "expectancy" because the employer had a right to modify the plan.[45] This ruling was emphasized by the court in *Dimock v. Corwin*[46] which pointed out,

> The right to nominate or designate the person to receive the death benefit could not have been levied upon to satisfy a judgment against the decedent during his lifetime; had he become bankrupt, his trustee could not have realized anything thereon for creditors, nor could it have been sold or assigned by the decedent because it was merely *a privilege extended to him by his employer, which was subject to withdrawal or modification at any time, under the quoted terms of the plan.*[47] (Emphasis added.)

Both the original treasury statement and the ruling in *Dimock v. Corwin* may be sound. As in the case of a transfer, the question should be one of fact and should depend upon whether the employer's action was designed as compensation for services.[48] In cases where payment by the employer to an employee's beneficiary are truly voluntary, it does not seem unsound to classify whatever interest the employee may have had as an "expectancy." However, when payments are made pursuant to a contract or long standing practice, a determination that such rights are an "expectancy" and not "property," seems unwarranted.

Nevertheless, in *Commissioner v. Twogood's Estate*,[49] the second circuit held that under an unfunded arrangement which was forfeitable, the interest transferred when a beneficiary was irrevocably designated was not "property" under the transfer provisions.[50] The court looked only at the moment of transfer because it said that the property and the transfer must be causaly related.[51]

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45 G.C.M. 17817, 1937-1 Cum. Bull. 281 (1937).

46 19 F. Supp. 56 (D.C.E.D. New York, 1937), *aff.*, on other grounds, 99 F.2d 799, *aff. sub. nom.* 306 U.S. 363.

47 *Id.* at 59. The Treasury changed its position in G.C.M. 27242, 1952-1 Cum. Bull. 160. But the ruling in Dimock v. Corwin was followed in Molter v. United States, 146 F. Supp. 497 (D.C.E.D. New York, 1956).

48 *Supra* note 29.

49 194 F.2d 627 (2d Cir. 1952).

50 Int. Rev. Code of 1939, § 811(c). Now § 2036(a)(1).

51 194 F.2d 627, 629.

It found that, at the moment of transfer, all that the decedent had prior to his reaching his retirement date was a right to receive an annuity which was contingent upon his meeting the requirements for retirement.[52]

In *Goodman v. Granger,*[53] the third circuit said that an interest under an unfunded deferred compensation contract containing contingencies was property includible in the gross estate under Section 2033. Although this statement is only dicta, because the interest had been originally included in the estate tax return and its includibility was not considered in the court below,[54] it does indicate a sound approach. Certainly the right to receive 10,000 dollars per year for ten years is a valuable right even if it is subject to certain conditions. If this right must be called "property" in order to impose a tax, then that term should be used.[55]

Even if it is decided that the interest under a deferred compensation arrangement is property within the meaning of an applicable estate tax provision, or is included in the gross estate under Section 2039, there is still the problem of valuing the interest.

In *Goodman v. Granger,*[56] the court made a thorough analysis of the valuation problem. If the employee's rights are subject to contingencies this may diminish their value to him; and if the right is unfunded the value may be further diminished because of the risk that the employer may become insolvent. In assessing value for gift tax purposes, these considerations are very troublesome because the gift tax must be paid at the time the transfer is made. However, the problems of estate tax valuation are much less complex. Valuation of an interest for estate tax purposes is neither logically nor feasibly administered until death has occurred, and so there is no objection to valuing an interest which passes at death as of the moment after death.[57] In fact, the

[52] *Id.* at 629. See Estate of William S. Miller, 14 T.C. 657 (1950); Estate of M. Hadden Howell, 15 T.C. 224 (1950).

[53] 243 F.2d 264 (3d Cir. 1957), *cert. denied,* 355 U.S. 835 (1957).

[54] 56-1 U.S.T.C. 55, 600 (D.C.W.D. Pa. 1956).

[55] See Charles B. Wolf, 29 T.C. 441 (1957), where the court held that an arrangement which was funded and forfeitable was an interest in property. Garber's Estate v. Commissioner, 271 F.2d 97 (3d Cir. 1959) also contains strong statements to this effect.

[56] *Supra* note 53.

[57] *Id.* at 268-269.

executor can choose an alternate valuation date, one year after death.[58]

Since the value in question is the value of the interest which passes by death, a court may disregard contingencies which fail to materialize. As the court pointed out in *Goodman v. Granger*,

> True the right to these payments was forfeitable upon the occurrence of any of the specified contingencies. However, forfeiture as a result of the contingencies never occurred during Blum's lifetime and any possibility of their occurrence was extinguished by his death.[59]

With contingencies disregarded, only the solvency of the obligor remains to diminish the value of the interest. The taxpayer can offer proof of this issue, but since the Commissioner's determination is presumptively correct, most attempts to lower acturial valuation called for in the Regulations[60] will fail.

If John Q. Executive has rights under a deferred compensation contract and retains these rights until he dies, the lawyer who plans his estate should proceed upon the assumption that these rights will be includible in his estate either under Section 2033 or Section 2039 as it has been thus far interpreted by the courts. However, if he wants to contest this question by relying upon such cases as *Twogood's Estate v. Commissioner*,[61] and arguing that Section 2039 applies only to annuities and other similar contracts, his chances of success will be materially improved if the contract is unfunded and subject to a large number of substantial contingencies.

On the other hand, if the deferred compensation contract is set up so that the employee receives no payments during his life, or he irrevocably transfers his right to receive payments and completely abandons control of the beneficial enjoyment, no part of the interest should be includible in the estate, unless the arrangement is found to be a gift in contemplation of death. Section 2036(a)(1) would not apply because the employee retained no interest for his life or for a period not ascertainable

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[58] Int. Rev. Code of 1954, § 2032.
[59] *Supra* note 53, at 269.
[60] Treas. Reg. Sec. 20.2031-7.
[61] *Supra* note 49.

without reference to his death or which does not in fact end until his death. Section 2039 does not apply either for the same reason.

Although there may be a few situations in which the estate planner would find it desirable to make a gift of the entire interest under a deferred compensation contract, such situations are unusual. It is usually wise to retain this interest during the life of the employee because it is a source of security during retirement, and because the employee will be required to pay tax on this income, even if the entire interest has been given away, and because, if the choice is between giving this asset or another asset, the deduction from income available to the beneficiary for estate taxes attributable to this item would be quite significant.[62]

Taxation of Payments Made After Death of the Employee

When payments are made to a beneficiary after John's death, the first question will be whether these payments are a gift. This, as we have already seen, is a question of fact to be decided on the basis of "practical human experience and the multiplicity of relevant factual elements."[63] If these payments are made pursuant to a deferred compensation contract, it would be almost impossible to conclude that a gift had been made. Therefore, we shall now consider the effect of payments after death of the employee which are found in fact to be compensation for services.

Section 101(b) of the Internal Revenue Code of 1954 deals with the first 5,000 dollars received by a beneficiary. It provides:

> (1) Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by or on behalf of an employer and are paid *by reason of the death* of the employee.
>
> (2) (A) (The limit of the total amount excludable is $5,000.)
> (B) (There is no exclusion for) *amounts* with respect to which the employee possessed, immediately before his death a *nonforfeitable right* to receive the amount while living. (This limitation does not apply to qualified plans.) (Emphasis added.)

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[62] See discussion of § 691 infra.

[63] Commissioner v. Duberstein, *supra* note 30, at 289; Compare Estate of Marvin G. Pierpont, 35 T.C. 65 (1960) with Louise K. Aprill, 13 T.C. 707 (1949).

An argument could be made that a payment made because of a contractual deferred compensation arrangement is not covered by this section because it is not made "by reason of the death of the employee." However, such an argument is not consistent with the legislative history of this provision. When first enacted in 1951,[64] the predecessor of Section 101(b) applied only to contractual payments. The Congressional reasoning was that death benefits paid by an employer are analogous to insurance payments and should be given similar preferential treatment.[65] Then in 1954, the committee reports state "Restricting the exemption to benefits paid under a contract discriminates against those who received benefits where this contractual obligation does not exist."[66] It is clear that the Congressional purpose was to expand the scope of this section, not to limit it.

The argument might also be made that a payment under a deferred compensation contract should not be included because it is merely a continuation of payment previously made to the employee. Such an argument may have some merit; this type of payment is not really similar to insurance. However, the employee's death is the *sine qua non* of the beneficiary's receipt of payments. Further, this provision does seem to contemplate payments of amounts which the employee might himself have received had he survived.[67]

In Section 101(b)(2)(B) we encounter a concrete reason for including contingencies in an unfunded deferred compensation plan. This provision applies to all "amounts" and the Regulations make it fairly clear that this limitation will apply to ordinary contractual rights.[68] When the contract is drafted, it should contain real contingencies and care should be used to insure that the contingencies will still exist when the employee dies. Failure to take this precaution will cost the beneficiary income tax on 5,000 dollars if an after death payment of 5,000 dollars or more is made.

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[64] Int. Rev. Code of 1939, § 22 (b)(1)(B) as amended by Revenue Act of 1951, 65 Stat. 483 (1951).

[65] Sen. Rep. #781, 82d Cong. 1st Sess., 50 (1951).

[66] H.R. Rep. #1337 83d Cong. 2d Sess., 14 (1954); Sen. Rep. #1622 83d Cong. 2d Sess., 14 (1954).

[67] Int. Rev. Code of 1954, § 101 (b)(2)(B), *supra.*

[68] Treas. Reg., Sec. 1.101-2(a)(2). For the status of this regulation see the *Hess* litigation, 31 T.C. 165 (1958), *rev.* 271 F.2d 104 (3d Cir. 1959).

Under Section 691(a) of the 1954 Code, "all items of gross income in respect of a decedent which are not properly includable in respect of the taxable period in which falls the date of his death or a prior period . . . shall be included in the gross income (of the beneficiary who receives them), in the year received."[69] The term "income in respect of a decedent" does not have an entirely clear meaning. However, if termination payments,[70] renewal commissions[71] and such noncontractual items as bonuses[72] and a year's additional salary[73] are "income in respect of a decedent," a payment made pursuant to a contractual obligation incurred as consideration for services rendered by the decedent should certainly come within the purview of Section 691.[74]

After including the amount received under a deferred compensation arrangement in his gross income, the beneficiary may be entitled to a deduction. Section 691(c)(1)(A) reads as follows:

> A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the *estate tax attributable*[75] to the *net value for estate tax purposes*[76] of all items described in subsection (a)(1) as the value for estate tax purposes of the items of gross income . . . bears to the value for estate tax purposes of all the items described in subsection (a) (1). (Emphasis added.)

The most significant single aspect of this provision is that it is not a credit against income taxes. It is a deduction from income. If there is a single Section 691(a) item paying the recipient 10,000 dollars and the estate tax attributable to this item is 3,000 dollars, then the total tax saving for a fifty per cent tax bracket

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69 For a history of the prior law see Nichols v. United States, 64 Ct. of Claims 241 (1927); 48 Stat. 694 (1934); Helvering v. Enright, 312 U.S. 636 (1941); H.R. Rep. #2333, 77th Cong. 2d Sess., 48 (1942).

70 Estate of Arthur W. Davis, 11 T.C.M. 814 (1952).

71 Latendresse v. Commissioner, 243 F.2d 577 (7th Cir. 1957), *cert. denied*, 355 U.S. 830 (1957); *Estate of Abraham Goldstein*, 33 T.C. 1032 (1960).

72 O'Daniel's Estate v. Commissioner, 173 F.2d 966 (2d Cir. 1949).

73 Bausch's Estate v. Commissioner, 186 F.2d 313 (2d Cir. 1951).

74 Flarsheim v. United States, 156 F.2d 105 (8th Cir. 1946); *but cf.* Lacomble v. United States, 177 F. Supp. 373 (D.C. N.D. Cal. S.D. 1959).

75 The "estate tax attributable" is determined by computing the estate tax with the net value of all § 691(a) items included, then computing the estate tax without the § 691(a) items. Finally subtract the second figure from the first. § 691(c)(2)(c).

76 "Net value for estate tax purposes" is the estate tax valuation of all the 691(a) items less all § 691(b) expenses in respect of a decedent § 691 (c)(2)(B).

recipient is 1,500 dollars, not 3,000 dollars. Nevertheless, this deduction is important to the estate planner, because this deduction can be affected by the selection of the beneficiary who is to receive payments after the employee's death.

Of course, if the item is not included in the estate at all there will be no deduction. There will also be no deduction if no estate tax was attributable to the item. However, let us suppose that before John dies he has the right to name a beneficiary who will receive 10,000 dollars per year for ten years after his death; and that the inclusion of the value of this right brings the value of the estate before taking the marital deduction to 500,000 dollars; and, finally, that the maximum marital deduction is taken.

If the right to receive deferred compensation goes to the wife, compute tax including Section 691 item:

Estate before M.D.	$500,000
Less Marital Deduction	250,000
Taxable Estate	$250,000
Tax on $250,000	$ 65,700
Less maximum state tax credit	3,920
Estate tax for Section 691(c) purposes	$ 62,780

Now compute tax excluding the net value of all Section 691 items, which in this situation would be 83,166 dollars.[77]

Estate before M.D.	$416,834
Less: Marital Deduction	166,834
(Under Section 691(c) the estate tax is to be recomputed without inclusion of this item at all.)	
Taxable Estate	$250,000
Tax on $250,000	$ 65,700
Less: maximum state tax credit	3,920
Estate Tax for Section 691(c) purposes	$ 62,780
Total Section 691(c) deduction	None[78]

Now suppose that this right passes at death to a beneficiary other than the wife. Compute the tax including the Section 691 item, as in the previous example:

[77] This figure represents the present discounted value of the right to receive income. See Treas. Reg. Sec. 20.2031-7 Table 11.

[78] See Drye, *The Taxation of a Decedent's Income*, 8 Tax L. Rev. 201, 214 (1953); *cf.* Estate of Thomas A. Desmond, 13 T.C.M. 889 (1954).

Estate Tax for purposes of Section 691(c)	$ 62,780
Recompute the tax omitting the Section 691 item	
Estate before M.D.	416,834
Less: Maximum Marital Deduction (Notice that the full $250,000 gift no longer qualifies)	$208,417
Taxable Estate	$208,417
Tax on $208,417	$ 53,225
Less: Maximum state tax credit on $208,417	2,842
Estate Tax for purposes of Section 691(c)	$ 50,383
Total Section 691(c) deduction	$ 12,397[79]

The foregoing example illustrates the advantage of an increased Section 691(c) deduction that will be gained by naming a person other than the employee's wife as a beneficiary under a deferred compensation arrangement. There is another obvious factor to be considered. Since the payments are income in respect of a decedent, the recipient must pay an income tax upon their receipt. Therefore, it is wise to select a beneficiary who is in the lowest possible tax bracket. In many cases the estate planner will find that a trust for the benefit of children and grandchildren is the ideal beneficiary.

The foregoing example also illustrates that careful planning for the deposition of an interest under a deferred compensation arrangement can effect important tax savings. Throughout this article an attempt has been made to turn the lawyer's attention to the gift and estate tax consequences of such arrangements as well as their income tax impact upon beneficiaries. With this knowledge the lawyer can participate more effectively in the drafting of these arrangements and can take steps even after the arrangement has been consummated which will result in substantial tax savings.

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[79] When the full marital deduction is being taken an approximation of the amount of the deduction obtained by giving a § 691 item to a beneficiary other than the widow may be made by dividing the value of the item in the estate by two and multiplying by the expected federal estate tax rate.