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PAYMENTS TO A CORPORATION OFFICER'S WIDOW IN INDIANA

As a result of both the modern trend in personnel policy to provide employees with greater fringe benefits and the fact that wives are surviving their husbands with increasing frequency, corporations are becoming more interested in making payments to widows of deceased corporate officers. Any corporation contemplating the making of such payments is faced with two immediate problems: (1) Are the payments *intra vires,* i.e., within the legitimate power of the corporation? (2) If so, can the payments be treated as deductible for federal income tax purposes?

In most states, these two broad issues are separable. However, in Indiana, the presence of an unconstrued and rather unfortunately worded statute complicates the matter:

> The board of directors of every corporation shall have power, subject to any restrictions contained in the articles of incorporation, to make contributions out of the gross income of the corporation to such entities, and for any one or more of such purposes, as such board may reasonably believe will constitute such contributions deductions from . . . gross income in computing the net income of the corporation subject to tax, pursuant to the provisions of the Internal Revenue Code as amended from time to time.[1]

If the statute is construed as governing the making of all contributions, noncharitable as well as charitable, the problems of corporate power and deductibility for tax purposes blend, the latter affecting the former because of the legislature's incorporation of federal tax standards. Since the legislature has not defined "contributions," the application of this statute to payments to widows of deceased corporate officers is not clear. Because of this as yet unresolved ambiguity, both the statutory and nonstatutory theories upon which the payments may be upheld as *intra vires* acts are explored. Although the ultimate conclusion is that the payments are probably supportable under any construction of the statute, no final choice of the "proper" theory is made; the matter is left to eventual judicial determination. Deductibility for tax purposes is discussed both for its intrinsic value and as an incident to one of the possible constructions of the statute.

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1. IND. ANN. STAT. § 25-211b (Burns 1960).

Problems Resulting From Indiana's Incorporation of the Internal Revenue Code

All statutes involving an incorporation by reference must face at least one general problem, that of the validity of legislative incorporation of a statute enacted in another jurisdiction when the incorporation constitutes an adoption of a law as it is and as it may be modified in the future.[2] The most persistent and difficult objection to state statutes involving incorporation by reference of prospective federal legislation is that such statutes constitute an invalid delegation of legislative power.[3] It is contended that if a state statute provides that some unknown future change in a federal statute will automatically become the law of the incorporating state, the legislature, in adopting the prospective measures, has unconstitutionally abdicated its legislative function.[4]

On the other hand, some courts have approved incorporation by reference of prospective legislation. The most frequent ground for upholding statutes of this nature is that the federal statute has been made a standard by which to determine a violation of the state statute.[5] This rationale is put forth clearly in *State v. Hotel Bar Foods, Inc.*:[6]

> The ultimate and controlling policy decision—as to whether there shall be uniformity of federal-state regulation in the field —rests always with the Legislature and it does not in any vicious sense abdicate its legislative judgment or authority. [Clearly, existing law can be adopted; unless prospective law may also be adopted] the state's policy of uniformity would as a practical matter be defeated.

The adoption of income tax provisions to determine the extent of cor-

2. Poldervaart, *Legislation by Reference—A Statutory Jungle*, 38 IOWA L. REV. 705, 707-08 (1953). As pointed out in Hayes, *Effect of Changes in Legislation Incorporated by Reference*, 43 MINN. L. REV. 89 (1958), there is even some controversy when the incorporations by reference concern only the law of another jurisdiction as it existed at the time of the incorporation and not as subsequently ammended. However, in the latter case the great preponderance of authority supports the validity of the incorporations. *Ibid.*

3. United States v. Barnaby, 51 Fed. 20 (9th Cir. 1892); United States v. Paul, 31 U.S. (6 Pet.) 141 (1832); McCartin, *The Constitutionality of the Federal Assimilative Crimes Act*, 17 FED. B.J. 157 (1957); Note, 70 HARV. L. REV. 685, 688 (1957).

4. State v. Vino Medical Co., 121 Me. 438, 117 Atl. 588 (1922); City of Cleveland v. Piskura, 45 Ohio St. 144, 60 N.E.2d 919 (1945).

5. *Ex parte Lasswell*, 1 Cal. App. 2d 183, 36 P.2d 678 (2d App. Dis. 1934); 310 Mich. 305, 17 N.W.2d 193 (1945); Mosher v. Haddock, 46 N.Y.S.2d 343 (Sup. Ct. 1944). For a general discussion of the theories which have been developed by the courts to defend against the objection that incorporation by reference is an unconstitutional abdiction of a state legislature's functions, see Mermin, *Corporate Federalism Again: State and Municipal Legislation Penalizing Violations of Existing and Future Federal Requirements*, 57 YALE L.J. 1, 9-14 (1947).

6. 18 N.J. 115, 124-25, 112 A.2d 726, 731-32 (1955).

porate powers appears to fall within this justification; the Internal Revenue Code and the regulations promulgated under it are used, in effect, as a standard for deciding what types of contributions are within the corporate power. As indicated by the court in the *Hotel Bar Foods* case, a state legislature which sympathizes with the policies of a particular federal enactment may legitimately adopt measures designed to have the state law keep pace with the federal law. Here federal-state uniformity has been achieved by the legislature's declaration that any expenditure in the nature of a contribution which is sufficiently related to the production of corporate income to qualify for deduction in determining federal income tax liability, is *a fortiori* authorized by state corporate law.

The legislative purpose behind section 25-211b is important in solving the problems connected with payments to widows because it not only must be used as a basis for the defense of the incorporation of federal law contained in that statute but also will have a bearing on the extent to which Indiana courts should follow federal interpretations of the assimilated portions of the Internal Revenue Code.

Although there is little available legislative history which could be used as the basis for attributing a legislative purpose to section 25-211b, it is likely that two objectives were foremost: (1) to assist corporations which are in the planning stage with regard to contributions by establishing a definite standard against which a planned contribution can be measured in determining whether it is *ultra vires* and (2) to liberalize state corporate law. In regard to the second objective, it should be noted that federal revenue laws are often premised upon collateral policies. For example, the liberal depreciation rules seek to encourage domestic capital investment. Thus, it could be argued that deductions for contributions to charities are provided not only because they are related to a profit motive in that they increase public goodwill toward the contributing corporations, but also because they promote the financing of charitable organizations through diversion of corporate funds. Similarly the legislature may have decided to liberalize state corporate law because it also recognized that corporate wealth and economic power place philanthropic and humanistic responsibilities on corporations. In this manner, corporations are given the opportunity to take full advantage of the tax laws, and the federal policy of encouraging contributions is furthered. This possible motive is strengthened by the recognition of such a public policy in judicial decisions which have sanctioned charitable payments by corporations through an extension of the doctrine of implied powers, allowing a corporation to engage in any activity that has even a remote relationship

to the corporation's purpose as set out in its charter.[7] In either instance, whether the legislature's purpose was to provide a readily ascertainable standard or to liberalize the corporate law, the legislature has done all that is within its power. The fact that uniformity with prospective federal provisions is highly desirable, if not essential, to carrying out the legislative policy, accompanied by the discernible trend to uphold legislative delegations of this nature, indicates that section 25-211b would be upheld if challenged as an unconstitutional delegation of legislative authority.

Definition of the Term "Contribution" as Incorporated

Whether a corporate payment to the widow of a deceased employee is authorized by section 25-211b will be determined in part by the definition assigned to the term "contributions" by the Internal Revenue Code and the regulations and decisions construing it and in part by resolution of the question of the extent to which the state courts are bound to accept that definition.

While the slight legislative history accompanying passage of 25-211b indicates that its supporters were primarily interested in making charitable contributions *intra vires*,[8] the statute as enacted did not limit the term "contributions" to payments of a charitable character.[9] The omis-

7. Harum, *The Emergence of the Economic Overdog*, 47 A.B.A.J. 286 (1961). A rationalization for allowing corporations to engage in programs of a charitable nature is that corporate foundations are much more efficient than the federal government. This efficiency results from the fact that a corporate foundation can determine when a genuine need exists and act almost immediately to fill this need, while the government must operate through the time-consuming device of congressional appropriation.

8. Section 25-211b was not included in the original version of the 1949 ammendments but was included in proposed ammendments to the original Senate Bill. *Memorandum In Respect of Proposed Ammendments To Senate Bill No. 112 Submitted by The Indiana Corporation Survey And The Committee on Legislative Programs of The Indianapolis Bar Association at The Hearing Held By the House Committee on Corporations on February 15, 1949.* Proposed ammendment Number 27 [12b (new section)]: "Specifically authorizes the board of directors to cause the corporation to make charitable contributions for purposes that the board may reasonably believe will make them deductible in computing the corporation's Federal income taxes." There is a marked similarity between this proposed ammendment and § 25-211b as it was enacted. However the fact that § 25-211b deleted "charitable" as a modifier of "contributions" indicates that the legislature had a broader purpose in enacting § 25-211b than those who supported the proposed ammendment to Senate Bill No. 112.

9. The statute is susceptible of three distinct constructions: (1) On the sole basis of the plain meaning of the text, the section appears to authorize the making of any payments which the directors reasonably believe will be deductible under any section of the Internal Revenue Code. (The directors may make any contributions which they believe "will constitute such contributions deductions" under the I.R.C.) The defects of a "plain meaning" construction are obvious: the statute would incorporate an extremely broad standard of deductibility. No ascertainable or effective meaning could be ascribed to the term, "contributions." (2) However, a more rational meaning appears if the plain meaning is supplemented by the consideration of what apparently was the principal purpose of the original draftsmen. In the original draft of the provision, the

sion is most significant, for it is clear that, while "contribution" is frequently used in the Internal Revenue Code and Treasury Regulations as a synonym for charitable contributions,[10] usage of the term is not limited to that context.[11] For example the Internal Revenue Code at section 404 provides for deductions for "contributions" by an employer to employee pension, profit-sharing, or annuity plans. Further, section 404(a)(5) allows a deduction "if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period). . . ." In addition, there are numerous cases where courts use "contributions" in referring to non-charitable corporate payments to various kinds of employee trust funds.[12] Therefore, if the Indiana courts follow the construction of the federal courts, they will consider "contributions" as referring both to charitable donations and to various other payments deductible as business expenses. This point has considerable importance for corporations contemplating payments to the widows of deceased employees since it is clear that the widow

authorization was limited to the making of "charitable contributions." On this construction, the defects of construction No. 1 disappear: The broad standard of deductibility is replaced by a reference to that distinctly separate complex of standards for the determination of deductions for charitable contributions, and the word "contributions" acquires an ascertainable meaning. But this construction is not inevitable; if the legislative intent was to authorize only charitable contributions, then the deletion of "charitable" in the final draft is inexplicable. It may have been a matter of mere inadvertance, or it may have been purposeful, the legislature intending to broaden the authorization beyond that contemplated by the original draftsmen. The issue is not capable of satisfactory resolution. (3) A third possibility exists which tends to avoid the uncertainties of the first two. The legislature may be taken to have authorized the making of such payments as would be "deductible as contributions," i.e. those payments which acquire deduction status by reason of I.R.S. provisions which call them "contributions." The effect of this construction is to broaden only moderately the apparent original purpose of the provision by incorporating not only the federal law as to charitable contributions but also those provisions such as § 404 of the I.R.C. which allows deduction of employer payments to employee trust, annuity, or deferred compensation plans. For it is clear that the I.R.C. usage of "contributions" is not limited to the context of charitable payments. Nevertheless, it must be admitted that, despite the rational compromise reached by this construction, there is no warrant for it on the face of the statute. If the legislature intended this result, its wording was not well-taken.

10. For example, in Treas. Reg. § 1.170-3 (1956): "Contributions or gifts by corporations . . . (a) In general. The deduction by a corporation in any taxable year for *charitable contribution* as defined in § 170(c), is limited to 5 percent of taxable income for the year."

11. Treas. Reg. § 1.170-1(c) (1956), provides that donation to individuals or corporations other than those referred to as eligible donees for charitable contributions, and which bear a direct relationship to the business and are made with a reasonable anticipation of financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses.

12. Wasatch Chemical Co. v. Commissioner, 313 F.2d 843 (10th Cir. 1963) (payment to profit sharing pension plan); Dejoy Stores Inc., *et al* v. Ryan, 229 F.2d 867 (2d Cir. 1956) (contribution to pension trust fund); Commissioner v. Surface Combustion Corp., 181 F.2d 444, 448 (6th Cir. 1950) (contribution to employee trust fund); Forbes Lithograph Mfg. Co. v. White, 42 F.2d 287 (D. Mass. 1930) (payment to foundation to assist employees).

is not within that class of donees to whom payments are deductible as charitable contributions under section 170(c) of the Internal Revenue Code. But the Commissioner is now attempting to have the status of such payments determined under section 404 which allows a deduction for "contributions" of an employer to employees' trust, annuity and deferred contribution plans.

If one assumes that the term "contributions" as used and interpreted in the code encompasses payments to widows of deceased officers, the question remains whether Indiana courts will follow such an interpretation. Professor Hart, a well-known authority on the relationship between state and federal law, has taken the position that the limit of a state legislature's power seems to be reached when it directs the state courts to conform as nearly as possible to the federal interpretations.[13]

If the federal court interpretation of the assimilated federal statute were binding on the state courts, the assimilated federal language would have no independent state law significance. Where a federal question exists, any interpretation of the assimilated federal language by a state court would be subject to review by the United States Supreme Court.[14] But several cases substantiate Professor Hart's view that a state cannot by unilateral appropriation "alter the distribution of federal and state powers by making federal law directly controlling in a sphere of exclusive state responsibility."[15] The absence of a federal question is quite certain when the incorporated federal law is used to define a term in the state statute and when the state applies the incorporated federal provisions in a subject area which was previously controlled only by state law. In these situations the interpretation which the state court puts upon the incorporated federal provisions is conclusive; but despite this fact, the purpose of the state statute may require that state courts voluntarily follow the federal court's construction of the incorporated federal statute.[16] Section 25-211b is an example of a situation where the state

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13. Hart, *The Relations Between State and Federal Law,* 54 COLUM. L. REV. 489, 536 (1954). Hayes, *supra* note 2, at 89, 113.

14. Standard Oil Co. of California v. Johnson, 316 U.S. 481, 483 (1942), held in effect that when a decision under state law necessarily involves the construction or validity of federal law the determination of such federal law gave rise to a federal question for review by the Supreme Court.

15. Hart, *supra* note 14, at 538. In State Tax Commission v. Van Cott, 306 U.S. 511 (1939), the court stated that it had no power of review if the state court was only incidentally referring to federal court decisions in determining the meaning of a state statute. This position is in agreement with the position taken by the Supreme Court in Minnesota v. National Tea, 309 U.S. 551 (1940), in which the court stated that just because state and federal constitutions contain the same words doesn't make the Supreme Court's interpretation of these words in the federal constitution binding upon the state court when it interprets them as they are used in the state constitution.

16. Note, 66 HARV. L. REV. 1498, 1503 (1953).

clearly has the power to make an independent interpretation of the assimilated federal law, since tax law provisions are being given legal efficacy in an area of the law where they were not previously operative, namely the areas of state corporate law which defines the limits of a corporation's power to make contributions.

However, there appear to be good reasons for Indiana courts not to exercise their option to ignore federal court interpretations. Although Indiana courts are not bound to follow the federal court interpretation of the provisions of the Internal Revenue Code incorporated by reference in section 25-211b, the legislative purpose attributed to this statute is still very important in determining what effect the state courts will give to federal court interpretation of the assimilated matter. If the purpose of section 25-211b were merely to provide a definite and easily ascertainable standard it would appear that the state courts would at least be bound to refer to the federal court interpretations of the assimilated federal statutes as "persuasive authority" in interpreting the state statute. This follows because the reason for requiring uniformity of interpretation of the assimilated statute is to allow corporations to plan their contributions without any doubts as to whether they are *ultra vires*. Since the provisions of the Internal Revenue Code on contributions have been extensively interpreted in numerous cases, following such interpretations would afford much greater certainty than if the state courts were completely free to make their own interpretations. Furthermore, since the words of a statute have little meaning until they are interpreted by the courts, the incorporated standard would be of little use if the state legislature did not also intend for the state courts to follow the federal interpretations of the incorporated provisions of the Internal Revenue Code.

If in addition to establishing a definite standard the legislature wished to liberalize state corporate law by linking it to the Internal Revenue Code's provision on deductible contributions, a strong argument can be made that any payment deductible under the Code, as interpreted by the federal courts, is *intra vires* under section 25-211b. This follows because an interpretation of the assimilated federal statute by the state courts which restricts the legal meaning of contributions to a greater extent than the federal court interpretation of the term would be in direct conflict with the purpose of liberalizing corporate law through this incorporation by reference. Therefore, although Indiana courts are not legally obligated to follow the federal judicial interpretations of the incorporated provisions of the Internal Revenue Code, they should voluntarily do so because such a course of action is in accord with the probable legislative purpose behind section 25-211b.

INCOME TAX QUESTIONS RESULTING FROM PAYMENTS TO WIDOWS OF DECEASED OFFICERS

Although "contributions" as used in the Internal Revenue Code and interpreted by the federal courts does encompass payments to widows of deceased officers and the Indiana courts should follow these federal court interpretations of the incorporated provisions of the Code when they interpret section 25-211b, a further step is required by that section before a board of directors can be sure that payments to widows are *intra vires*. Since section 25-211b gives the board of directors power to make contributions *if* these contributions *will constitute* deductions from gross income for tax purposes, it is necessary to determine to what extent payments to widows can be considered deductible under the Internal Revenue Code. If payments are non-deductible under the Code they may be *ultra vires* under section 25-211b. Thus a corporation planning to make payments to widows of deceased officers is primarily concerned with whether such payments are "ordinary and necessary" business expenses under section 162 of the Internal Revenue Code of 1954, which establishes no limitations on such deductions, or whether these payments will fall under other sections of the Internal Revenue Code of 1954 which impose limitations of one form or another.[17] Despite the considerable amount of litigation on the deductibility of such payments the issue remains unsettled.

The Commissioner of Internal Revenue initially took an extremely lenient position on this question in a ruling under the Internal Revenue Code of 1939.[18] In essence this ruling stated that payments made to a widow of a deceased employee, which were designated in a manner consistent with the concept of gifts and which did not exceed the deceased's yearly salary, could be deductible as an "ordinary and necessary" business expense by the corporation making the payment even if made in the absence of a contractual obligation; but such payments should not be includible as income to the widow. The formula for whether a payment was a gift was whether the recipient had rendered any service for the allowance paid to her.[19] However, the Commissioner soon became displeased with the way that corporations were incorporating the literal language of this ruling into the corporate resolutions authorizing pay-

17. Specifically the question is whether such payments will fall under § 170 dealing with charitable contributions, under § 101(b) dealing with employee death benefits, under § 404(a)(5) dealing with contributions to employee trust or annuity plans, or under § 274(b) which limits gifts deductible as "ordinary and necessary" business expenses to $25 per recipient per year.

18. I.T. 3329, 1939-2 CUM. BULL. 153.

19. *Ibid.*

ments to widows. They then deducted such payments as an "ordinary and necessary" business expense, and the widow treated the payments as a gift to her despite circumstances which indicated that the payments were in return for services rendered by her.[20] In the cases which followed, the courts took the position that in the absence of a contractual obligation on the part of the corporations the payments were to be considered gifts and not deductible as business expenses by the corporation.[21]

Under the Internal Revenue Code of 1954 the Commissioner took the position[22] that the deductibility of such payments as an expense of the employer should be determined under section 404 which is concerned with employee's trust, annuity, or deferred compensation plans.[23] The attempt of the Commissioner to have the deductibility of payments to widows determined under section 404 instead of section 162 is the result of his theory that such payments should be deductible by the employer only if they are taxable income to the recipient. The Commissioner advanced this theory in *Commissioner v. Duberstein*[24] in support of a proposal that the court accept a new definition of gifts for income tax purposes. The definition proposed was "a transfer for personal as distinguished from business reasons." In proposing this new definition the Commissioner urged that the gift concept is inconsistent with the treatment of the payment as a deductible business expense of the payor.

The Supreme Court in the *Duberstein* case rejected the Commissioner's contention and held that the true criterion to be used to determine whether a payment was a non-deductible gift for tax purposes is whether a "detachable, disinterested generosity" was the basic reason for the taxpayer's conduct. This question was held to be one that should be decided by the trier of fact. Subsequent cases concerning corporate payments to

20. Louise K. Aprill, 13 T.C. 707 (1949), where the widow became president of the corporation and performed minor administrative functions. Payments of $16,000 were held to be gifts under the language of I.T. 3329.

21. Commissioner v. Bear Film Co., 219 F.2d 231 (9th Cir. 1955); Black v. Davis, 55-1 U.S. Tax Cas. 9361 (N.D. Ala. 1955).

22. Rev. Rul. 55-212, 1955-1 CUM. BULL. 299. This ruling provides among other things ". . . if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period) and if such amounts meet the requirements of § 162 or 212, such amounts are deductible under § 404(a)(5). . . ."

23. However, as stated in Rev. Rul. 54-625, 1954-2 CUM. BULL. 85, whether the payments are treated as business expense under § 162(a) of the 1954 Internal Revenue Code or as compensation under a deferred compensation plan under § 404, the payments must be for a "limited period" which is construed as referring to the reasonableness of the total amount rather than the length of the period in which such amounts are to be paid.

24. 363 U.S. 278 (1960).

widows have followed the Supreme Court's position and have held that no legal obligation on the part of the corporation is necessary to make such a payment deductible as an "ordinary and necessary" business expense so long as the corporation has a compensatory intent.[25] Substantially returning to the view originally taken by the Commissioner under the 1939 Code the Tax Court in a recent case stated that the fact that such payments actually constitute gifts to the widow did not militate against their character as "ordinary and necessary" business expenses.[26]

The cases indicate that the Commissioner's proposal that a payment be deductible by a corporation as a business expense only if it is taxable income to the widow has been rejected. However, Congress seemed to accept the Commissioner's position when it was considering section 274(b), which limits deductions of gifts as "ordinary and necessary" business expenses to twenty-five dollars per recipient per year. This apparent acceptance is contained in a Senate Committee Report[27] which states, in effect, that a payment which was not considered as part of the recipient's gross income for tax purposes would be considered a gift by the donor for the purpose of the twenty-five dollar per recipient limit of gifts as "ordinary and necessary" business expenses deductible by the donor. Based on this apparent adoption by Congress of the Commissioner's position a strong argument could be made that payments to widows must be income to them before the payor corporation can deduct these payments as business expenses.[28] While the apparent Congressional endorsement of the Commissioner's position has yet to be embraced by the judiciary, Treas. Reg. 1.274-3(b)(1) defines gift as "any item excludable from the gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of Chapter 1 of the Code." The regulation then states that as a result of the $5,000 exclusion from gross income of the recipient provided by section 101(b) payments by an employer to a deceased employee's wife up to $5,000 are not gifts for the purposes of section 274(b). This implies that payments to the widow in excess of $5,000 will be considered

25. Fifth Avenue Coach Lines Inc. v. Commissioner, 31 T.C. 1080 (1960); Champion Spark Plug Co. v. Commissioner, 30 T.C. 295 (1958), *aff'd*, 266 F.2d 347 (6th Cir. 1959).

26. J. Avon & Co. v. Commissioner, 22 C.C.H. Tax Ct. Mem. 788 (1963).

27. S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

28. The situation is somewhat different when payments are made to a widow of a deceased officer who was also a stockholder. In this situation the Commissioner has taken the position that such payments may constitute constructive dividends which are non-deductible profit distributions rather than being considered as additional compensation for the services of the deceased officer and thus deductible as an "ordinary and necessary" business expense. The factors which are considered in each individual case before accepting or rejecting the Commissioner's position are discussed in Rubber Associates Inc. v. Commissioner, 335 F.2d 75 (6th Cir. 1964).

a gift excludable from her gross income by reason of section 102, and a deduction in computing the income tax liability of the corporation would not be allowed in excess of twenty-five dollars.

The only policy against the Commissioner's position is that it fails to take into account the social problems and hardships which may be imposed upon the widows of deceased employees. The argument would proceed along the line that the situation of the widow is analogous to other social problems and hardships such as blindness and old age for which there are special tax allowances. However, this argument loses most of its force when the provisions of section 101(b) are taken into account since the widow would still be permitted to exclude from income corporate payments except for the extent to which they exceed $5,000. In addition, that argument is weak when payments to widows of deceased officers are concerned since such widows are quite likely to be in an above average financial position.

If the Commissioner's position that a corporation may take a deduction as "ordinary and necessary" business expense for payments to a deceased employee's widow only if this payment is income to the widow is in fact the law, then a corporation planning to make such payments must ascertain when such payments will be held to be income to the widow. In other words, the effect of the Commissioner's position would be to make the issue of deductibility dependent upon a determination of the nature of the payment in the hands of the recipient. When confronted with the question of the character of the payment in the hands of the recipient, courts have frequently commented on whether the corporate payor has claimed a deduction on the grounds that the payments were compensation; but this fact has apparently been attributed significance only as evidence of the payor's intent.[29]

After several court decisions held voluntary payments to widows to be gifts to them rather than taxable income, the Internal Revenue Service adopted the position[30] that it would not litigate this issue under the 1939 Code unless there was clear evidence that such payments were intended to be compensation for services. At the same time, the Commissioner indicated that he would continue to litigate the question under the 1954 Code. The Commissioner's view is that any obligation between employer and employee, even if it is only a moral obligation or one arising out of a plan to keep valuable employees happy, rules out a gift and makes the payment taxable income to the widow.[31] This hard-nosed position was

29. See, *e.g.*, Evans v. Commissioner, 330 F.2d 518 (6th Cir. 1964).
30. Rev. Rul. 50-613, 1958-2 CUM. BULL. 914.
31. Simpson v. United States, 261 F.2d 497, 501 (7th Cir. 1958); Bausch's Estate v. Commissioner, 186 F.2d 313 (2d Cir. 1951).

put forth in a 1950 Revenue Ruling[32] which stated:

> Irrespective of a plan, voluntary, or involuntary, definite or indefinite, payments by an employer to the widow of a deceased officer or employee in consideration of services rendered by the officer or employee are not gifts but are includable in the gross income of the widow, provided such payments weren't received prior to January 1, 1951.

The Commissioner has also withdrawn his previous position that Congress, in enacting section 101(b) which provides for the exclusion from gross income of the first $5,000 of payments which are received by reason of the death of an employee, presupposed that all such payments constitute income.[33] Thus in a case involving a voluntary payment by the corporation, the dispute is now limited to a question of fact: Does payment represent payment for past services of the deceased employee (income), or does it express a donative intent on the employer's part towards the widow (gift)?[34] When the courts have been called upon to make this determination they have reached conflicting results. The traditional line between taxable compensation and non-taxable gifts was first drawn in *Bogardus v. Commissioner*,[35] which stated that a payment is a gift if made "in recognition of, not payment for former services." The district and circuit courts still follow that general guideline in holding that whether such payments are gifts depend on the intent of the payor.[36] However, the Tax Court has used the decision in *Commissioner v. Duberstein*[37] to hold that payments to widows are not gifts because they do not arise from a "detached and disinterested generosity."[38]

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32. I.T. 4027, 1950-2 CUM. BULL. 9, at 10-11.

33. The Commissioner was unsuccessful in litigation of this question and withdrew his contentions in Rev. Rul. 62-102. See, *e.g.*, Reed v. U.S., 177 F. Supp. 205 (W.D. Ky. 1959) *aff'd sub nom.* 277 F.2d 456 (6th Cir. 1960); Rice v. U.S., 197 F. Supp. 223 (E.D. Wis. 1961); Cowan v. U.S., 191 F. Supp. 703 (N.D. Ga. 1960); Frankel v. U.S., 192 F. Supp. 776 (D. Minn. 1961). Contrary to the Commissioner's contention, the above cases concluded that the purpose of the 1954 addition of § 101(b) was to eliminate the requirement of the corresponding section of the 1939 code, § 22(b)(1)(8), which granted exclusion in the amounts of $5,000 only where the payment was made pursuant to contract; the 1954 version thus did not purport to change the existing law that a gift is excludable in its entirety but merely abrogated the distinction between contractual and non-obligatory payments.

34. Note, 49 KY. L.J. 531 (1961).

35. 302 U.S. 34 (1937).

36. Peters v. Smith, 221 F.2d 721, 725 (3d Cir. 1955); Rodner v. United States, 149 F. Supp. 233, 237 (S.D.N.Y. 1957).

37. 363 U.S. 278 (1960).

38. Coopers Estate v. Commissioner, 20 C.C.H. Tax Ct. Mem. 774 (1961); Fisher v. Commissioner, 20 C.C.H. Tax Ct. Mem. 318 (1961); Cronheim v. Commissioner, 20 C.C.H. Tax Ct. Mem. 1144 (1961). As pointed out in Note, 49 VA. L. REV. 74, 123 (1963) the tax court has stopped just short of holding that all payments in excess of $5,000 will be considered income to the widow unless she is in bad financial circumstances of

The law is still unsettled with regard to the tax consequences of payments by corporations to widows of deceased officers. However, the Commissioner is taking a logical and consistent position in contending that a corporation's payment to a widow of a former employee can not be a business expense to the corporation without being taxable income to the widow. Taking the contrary position amounts to looking at only one side of the entire transaction while ignoring the other. It is a patent absurdity for a court to hold that a payment by a corporation to the widow of a deceased corporate employee is deductible as a business expense because it was made with a profit-orientated motive, and then to declare the payment to be a gift in the hands of the widow because the basic reason for the payment was a "detached and disinterested generosity" on the part of the corporate payor. The Senate Report may be a good indication that the Commissioner's viewpoint will be accepted by the courts in the future. The question as to what is necessary before a voluntary payment by a corporation to the widow is treated as taxable income of the widow is a little more uncertain. It seems that the conflict between the Tax Court and the district and circuit courts on this question is reconcilable in that they both recognize that the basic requirement to make a payment taxable to the widow is that it have some definite relation to the deceased employee's salary or wage and thus manifest a compensatory intent on the part of the corporation.

A corporation faced with the confusion in the law as to the deductibility of payments to widows, and the possibility that such payments will be held *ultra vires* under section 25-211b unless deductible under the Internal Revenue Code, can protect itself by making sure that the payments have a clear relation to the salary of the deceased employee and are expressly given in consideration for the services which he rendered to the corporation during his lifetime. This would probably guarantee that a court would consider these payments income to the widow and deductible to the corporation even if the Commissioner's position originally set forth in *Duberstein* is adopted. Any attempt by a corporation to make payments which might be found to be gifts to the widow runs the risk that the deduction claimed by the corporation might be disallowed under the Internal Revenue Code and thus *ultra vires* under section 25-211b. Such an attempt by a corporation is especially risky in view of the fact that the Commissioner's position on the deduction-gift question appears to be gaining acceptance.

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which the corporation is aware and unless the amount of the payments are determined by reference to her financial needs.

CORPORATE POWER TO MAKE PAYMENTS TO WIDOWS OF OFFICERS UNDER THE COMMON LAW

Although payments to widows are deductible under certain circumstances, the law in regard to the deductibility of such payments is quite unsettled. Since the coverage of section 25-211b is tied to deductibility, a corporation might be rather uncertain as to whether payments to widows made in the absence of a legal obligation are *ultra vires* if section 25-211b is exclusive in so far as determining whether such payments are *ultra vires*.[39] However, it can be argued that section 25-211b is a permissive statute, and that no negative inference should arise under it that contributions which are non-deductible are automatically *ultra vires*. To allow such a negative inference would impute a restrictive meaning to a permissive statute with a resulting frustration of the legislative purpose. Consequently, although a payment might not be within section 25-211b, it still might be *intra vires* and legal under the general principles of corporation law.

Because a corporation is given certain legal advantages such as limited personal liability for its stockholders, the doctrine of *ultra vires* has established that a corporation can do only those things for which it has authorization by its charter or by the general corporate law of the states in which it is incorporated.[40] However, the expressed powers which are given to the corporation by the charter carry with them the power to engage in transactions incidental to the business of the corporation.[41] As a result, the essential question in determining whether an act is *ultra vires* is whether it has a logical relation to the corporate purpose as set out in its charter. In each individual case, this question must be answered by considering the expressed powers and purpose of the particular corporation and the business situations with which it is faced.[42]

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39. There is a collateral question involved in Indiana as to the effect of the 1949 ammendments to the Indiana General Corporation Act passed in 1929 on corporations which where given their charters between 1929 and 1949. In Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819), it was held a state could not pass a law which in effect ammended a corporate charter since this would impair a contract and thus be unconstitutional. The decision suggested that the states reserve the power of ammendment of corporate charters and this suggestion was followed by virtually all of the states. However, Indiana did not reserve such a power to amend until 1949. Thus it could be argued that if § 25-211b allows corporations to make contributions which were *ultra vires* under the 1929 General CorporationAct; this results in effect in an ammendment to the charters of corporations who were incorporated between 1929 and 1949 with a resulting unconstitutional impairment of the contracts represented by these charters.

40. Cousens, *How Tax Corporations May Contribute to Charity*, 35 VA. L. REV. 401, 409 (1949).

41. Central Transp. Co. v. Pullman's Palace Car Co., 139 U.S. 24 (1891); Green Bay & Minn. R.R. v. Union Steamboat Co., 107 U.S. 98 (1882).

42. See Jacksonville M.P. Ry. v. Hooper, 160 U.S. 514 (1880).

In situations where the above questions are asked with regard to corporate payments to employees, the courts have recognized that some donations are justified if they result in the accomplishment of employee satisfaction. This follows from the fact that a corporation for profit can not accomplish its objective unless it keeps its employees satisfied by giving them reasonably considerate treatment.[43] When any payment is challenged as *ultra vires* the courts have insisted that there be a showing that the expense involved can reasonably be expected to promote the business interest of the corporation and to result in a distinct and direct benefit to it.[44]

In applying the above standards, courts have found that the granting of pensions and other payments by corporations to retiring employees are within the corporation's power because such payments would be likely to have a direct bearing on the successful operation of the business by (a) helping a corporation to acquire the best employees, (b) raising the quality of services they would render to the corporation, and (c) increasing the length of their service and loyalty.[45]

There are few cases directly on point as to whether payments to widows of deceased officers which are not made in performance of a pre-existing contract constitute an acceptable corporate action or an *ultra vires* one. One such case, *Moore v. Keystone Macaroni Mfg. Co.*[46] involved a board of director's authorization of a payment to the widow of the long time president of the company. In holding the payment *ultra vires,* the court gave the following reasons: (1) the widow had not performed any services for the corporation; (2) the Pennsylvania statute did not give corporate directors discretion to make such payments; (3) the trend of court decisions in allowing corporations to make charitable gifts and set up pensions was irrelevant since neither were involved in this case; (4) allowing such payments would open the door to dissipation of corporate assets; and (5) the fact that such payments are deductible under the federal tax laws is irrelevant. However, the situation in the *Macaroni* case was complicated by circumstances which normally are not present in cases of payments to the surviving spouses of deceased officers,[47] and as a result the rule of this case has a rather narrow

43. Cousens, *supra* note 41, at 406.

44. American Rolling Mill Co. v. Commissioner, 41 F.2d 314 (6th Cir. 1930); Steinway v. Steinway & Sons, 17 Misc. 43, 40 N.Y. Sup. 718 (Sup. Ct. 1896); Appeal of Poinsett Mills, 1 B.T.A. 6 (1924).

45. Heinz v. National Bank, 237 Fed. 942 (8th Cir. 1916); Henderson v. Bank of Australia 40 Ch.D. 170 (1888); Cyclists Touring Club v. Hopkins, 1 Ch. 179 (1910); Normandy v. Ind. C. & C., 1 Ch. 84 (1908).

46. 370 Pa. 172, 87 A.2d 295 (1952).

47. Comment, 101 U. PA. L. REV. 153 (1952), points out these unique circumstances. First, the decedent was majority stockholder and the executor of his estate

application.

Although there is a lack of cases directly on point with which to rebut the holding of the *Macaroni* case, the cases concerning pensions and bonuses for past services can be used to obtain an idea of corporate law in this general area.[48] As is indicated by the rejection of these cases in the *Macaroni* case, they fail to support the position taken by that court. The early cases established the general rule that bonuses or pensions which amounted to compensation for past services rendered gratuitously or for a fixed compensation were made in the absence of any legal obligation on the part of the corporation; and in such circumstances these payments could not be made over the opposition of any stockholder of the corporation who challenged them on the grounds that they constituted *ultra vires* acts. The later cases have continued to recognize this rule but have made exceptions to it where the amount of the bonus or pension is reasonable in view of the services rendered.[49] Recent cases have emphasized the requirement that the payments have a reasonable relationship to the services rendered by the employee.[50] Thus it has been held that payments for past services of a corporation's employees are not *ultra vires* where properly awarded, as in connection with a plan for participation in the corporation's profits or to promote loyalty and efficiency of employees.[51] The reasoning of the courts seems to be that payments to employees who have contributed to the corporation's success are really not gratuitous in nature despite the absence of legal obligation on the corporation's part. Such payments have a profit-oriented motive since they are made with the expectation that they will perpetuate the kind of performance by employees that is necessary for profitable operations in the future.

Bonuses for past services which are paid to officers or directors will be examined more carefully than similar payments to regular employees because such examination is necessary to protect stockholders

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was a member of the board of directors. Second, the main reason for the payment was to keep decedent's family satisfied while a determination was made as to whether decedent's son or another more experienced executive would become president.

48. Maux Ferry Gravel Road Co. v. Branigan, 40 Ind. 361 (1872); National Loan and Investment Co. v. Rockland Co., 36 C.C.A. 370, 94 Fed. 335 (8th Cir. 1889); Ellis v. Ward, 137 Ill. 509, 25 N.E. 530 (1890); Moss v. Copelof, 235 Mass. 162, 126 N.E. 474 (1920); Beers v. New York Life Ins. Co., 66 Hun. 75, 20 N.Y.S. 788 (1892).

49. Baynum v. Johnson, 127 F.2d 491 (8th Cir. 1942), *modifying*, 41 F. Supp. 355 (D.C. Civ. 1941); Wiseman v. Musgrave, 309 Mich. 523, 16 N.W.2d 60 (1944); Wineburgh v. Suman Bros., 21 N.Y.S.2d 180 (1940).

50. Rogers v. Hill, 289 U.S. 582 (1932); Fuch v. National Casting Co., 201 F. Supp. 451 (N.D. Ohio 1962); Fry v. National Projections Inc., 306 S.W.2d 465 (Mo. 1958); Osborne v. United Gas Improvement Co., 51 D. & C. 383 (1944), *affirmed*, 354 Pa. 57, 46 A.2d 208 (1945).

51. Spaeth v. Journal Plumbing Co., 139 F. Supp. 188 (1956); Neff v. Gas & Elec. Shop, 232 Ky. 66, 22 S.W.2d 265 (1929).

from fraud. The basis for this scrutiny is that officers are in a position to exert undue influence in procuring bonuses which are not justified by job performance. Similarly, this argument could be used to hold that payments to widows of deceased officers were not proper because they have no profit motive and because the widow might exert undue influence on the corporation, especially if the deceased officer was also a major stockholder. However, bonuses to officers or directors will not be *ultra vires* merely because the recipients are officers.[52] This rule should apply with equal force to payments to surviving spouses of deceased officers. Following this general proposition, it was held in *In re Woods Estate*[53] that a resolution by the board of directors providing payment of deceased officer's salaries to their estates for one year following the officer's death was *intra vires.* In the *Woods* case the court held that the resolution, adopted ten months prior to the officer's death, was an inducement to the corporation's officers to continue their employment and that the decedent's reliance upon this inducement by remaining with the company created an obligation on the company's behalf.

The cases cited above have established a definite trend toward expansion of corporate powers to enable corporations to make payments to their employees in the absence of contractual obligations. This trend is a result of two factors. First, it is merely another example of the general decline in the concept of *ultra vires* as a device to limit the operations of a corporation; and second, it reflects the courts' recognition that payments which are made in the absence of a contractual obligation and which do not have an immediate beneficial effect on corporate operations may nevertheless be motivated by profit and be designed to produce a long range increase in corporate earnings. In view of this trend, a corporation could make a strong argument that payments to widows of deceased officers were *intra vires* if it could show that the payments were reasonable and had the collateral effect of improving employee satisfaction, loyalty, and job performance. Corporate payments to widows also might be thought of as simply another fringe benefit to corporate officers and therefore obviously within corporate powers. The major obstacle to such a conception of these payments is their non-contractual nature. However, the absence of a contractual obligation does not eliminate profit motivation; and it is the profit motive which makes officer compensation and fringe benefit plans *intra vires.*

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52. Mann v. Luke, 44 N.Y.S.2d 202 (1943); Renn v. Asbestos Mfg. Co., 101 F.2d 344 (7th C.C.A. 1938), *cert. denied,* 308 U.S. 555 (1939).

53. 299 Mich. 635, 1 N.W.2d 19 (1941).