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The Legal Benchmarks of a Plan for Employees: A Navigational Framework under Section 105

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THE LEGAL BENCHMARKS OF A PLAN FOR EMPLOYEES: A NAVIGATIONAL FRAMEWORK UNDER SECTION 105

Section 105 of the Internal Revenue Code of 1954[1] provides three vehicles by which an employer's payments of sick pay and other

1. (a) AMOUNTS ATTRIBUTABLE TO EMPLOYER CONTRIBUTIONS.—Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

(b) AMOUNTS EXPENDED FOR MEDICAL CARE.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(e)) of the taxpayer, his spouse, and his dependents (as defined in section 152).

(c) PAYMENTS UNRELATED TO ABSENCE FROM WORK.—Gross income does not include amounts referred to in subsection (a) to the extent such amounts—

(1) constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent (as defined in section 152), and

(2) are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

(d) WAGE CONTINUATION PLANS.—Gross income does not include amounts referred to in subsection (a) if such amounts constitute wages or payments in lieu of wages for a period during which the employee is absent from work on account of personal injuries or sickness; but this subsection shall not apply to the extent that such amounts exceed a weekly rate of $100. The preceding sentence shall not apply to amounts attributable to the first 30 calendar days in such period, if such amounts are at a rate which exceeds 75 percent of the regular weekly rate of wages of the employee (as determined under regulations prescribed by the Secretary or his delegate). If amounts attributable to the first 30 calendar days in such period are at a rate which does not exceed 75 percent of the regular weekly rate of wages of the employee, the first sentence of this subsection (1) shall not apply to the extent that such amounts exceed a weekly rate of $75, and (2) shall not apply to amounts attributable to the first 7 calendar days in such period unless the employee is hospitalized on account of personal injuries or sickness for at least one day during such period. If such amounts are not paid on the basis of a weekly pay period, the Secretary or his delegate shall by regulations prescribe the method of determining the weekly rate at which such amounts are paid.

(e) ACCIDENT AND HEALTH PLANS.—For purposes of this section and section 104—

(1) amounts received under an accident or health plan for employees, and

(2) amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance.

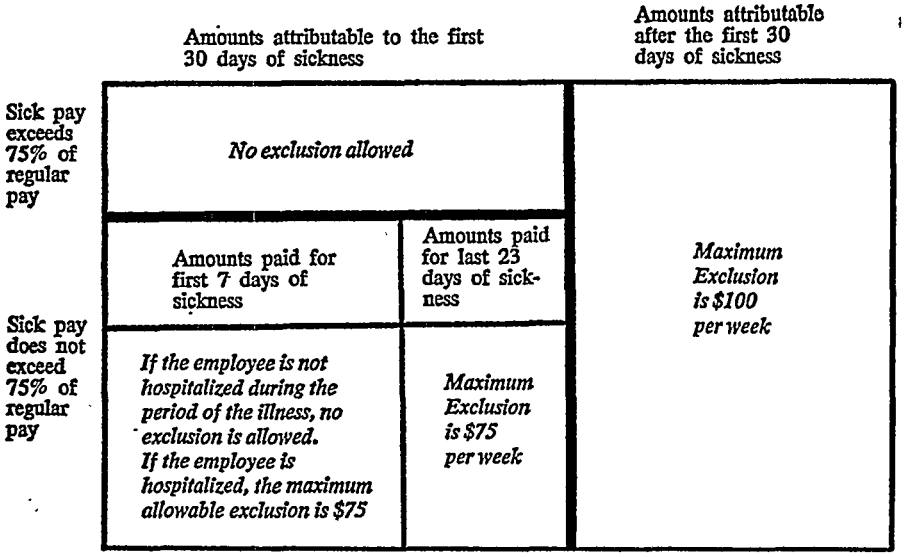
(f) RULES FOR APPLICATION OF SECTION 213.—For purposes of section 213(a) (relating to medical, dental, etc., expenses) amounts excluded from gross income under subsection (c) or (d) shall not be considered as compensation (by insurance or otherwise) for expenses paid for medical care.

(g) SELF-EMPLOYED INDIVIDUAL NOT CONSIDERED AN EMPLOYEE.—For purposes of this section, the term "employee" does not include an individual who is an employee within the meaning of section 401(c)(1) (relating to self-employed individuals).

medical benefits to employees will not be included in the recipient's gross income. These include payments under a commercial insurance plan,[2] a state disability fund,[3] and an employer-sponsored accident or health plan "for employees."[4] This Comment will identify the requisite elements of a health and accident plan, as well as the criteria used in deciding whether or not the plan is "for employees."

INT. REV. CODE OF 1954, § 105. Section 105 considers three basic purposes which may be the legitimate object of payments: (1) payments to compensate the employee for lost wages while sick, (2) payments to compensate the employee for the loss of a function or member of his body, and (3) payments to compensate the employee for medical expenses incurred for himself, his spouse, or his dependents.

In the case of wage continuation plans, the amount excludable from the recipient's income is limited by complex rules. After the first thirty days of sickness, the employee may simply exclude his sick pay not in excess of $100 per week. Excludability of payments received during the first thirty days of sickness, however, is subject to further conditions. If the sick pay exceeds 75% of the employee's regular pay, no amount is deductible for the first thirty days. If it does not exceed 75%, the employee may exclude $75 per week for the last three weeks of the first month, but he may not exclude anything for the first week unless he has been hospitalized for at least one day during the period of the illness, in which case $75 is excluded in the first week. The following chart may illustrate these limitations.



To exclude payments designed to compensate an employee for loss or loss of use of a member or function of the taxpayer's body (or permanent disfigurement), the loss must be permanent and may be computed with reference only to the nature of the injury and not with regard to the period of the employee's absence.

2. *Id.* § 105(a). Although the statutory language does not use the word "commercial," the legislative history of this section indicates that this would be the probable construction, should the issue ever arise. See text accompanying notes 7-10 *infra.*

3. INT. REV. CODE OF 1954, § 105(e)(2).

4. *Id.* § 105(e)(1).

The lion's share of case law on health and accident plans has arisen in the context of the closely-held corporation.[5] The close corporation's plan, in contrast to the plan of the larger publicly-held corporation, is more likely to fail because an attorney or accountant is less frequently consulted. Moreover, the recipients under the plan generally have an equity interest in the employer-corporation, a factor which casts doubt on the existence of the "for employees" requirement. While a superficial examination of the cases seems to suggest the impermissibility of a plan compensating only employee-shareholders, a more detailed reading reveals a reconcilable interpretation sanctioning such plans.

I. The Existence of a Plan

Section 105's legislative history indicates that the purpose of the "plan" requirement was to equalize the tax treatment between insured and uninsured plans.[6] Prior to the 1954 amendments, employer-funded plans were required to come within the definition of "insurance" imposed by the 1939 Code.[7] Contrariety of opinion among the circuits produced a variety of standards for defining "in-

5. Of approximately nineteen cases dealing with these two issues, fourteen involved close corporations: Estate of Chism, 322 F.2d 956 (9th Cir. 1963), *aff'g* 21 CCH Tax Ct. Mem. 25 (1962); Barron v. United States, 17 Am. Fed. Tax R.2d 334 (W.D. Pa. 1966); American Foundry, 59 T.C. 231 (1972); Samuel Levine, 50 T.C. 422 (1968); Alan B. Larkin, 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968); Charlie Sturgill Motor Co., 32 CCH Tax Ct. Mem. 1336 (1973); Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); Timothy L. Pickle, Jr., 30 CCH Tax Ct. Mem. 1300 (1971); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970); Rosario Occhipinti, 28 CCH Tax Ct. Mem. 978 (1969); Edward D. Smithback, 28 CCH Tax Ct. Mem. 709 (1969); Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968); Jack M. Burr, 25 CCH Tax Ct. Mem. 592 (1966); Edward A. Bernstein, 20 CCH Tax Ct. Mem. 804 (1961). To date, the cases dealing with publicly-held corporations are: Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965); Andress v. United States, 198 F. Supp. 371 (N.D. Ohio 1961); John C. Lang, 41 T.C. 352 (1963); Estate of Kaufman, 35 T.C. 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962).

6. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 15 (1954). The report provides:

> Under present law, amounts received as accident or health benefits are exempt only if the benefits are paid under a contract of insurance. This results in substantially different tax treatment to recipients of sickness and accident benefits who are similarly situated except for the technical nature of the plan under which the benefits are made available. Moreover, very troublesome legal and administrative problems have arisen in determining whether particular plans, especially self-insured plans which are financed by employers without the use of a carrier or insurance company, constitute insurance for purposes of the exemption.
>
> Your committee's bill grants equal tax treatment to sickness and accident benefits financed by employers whether paid under insured and noninsured plans.

Id.

7. *Id.*

surance."[8] The 1954 provision eliminated this insurance element; however, the Congress explicitly stated that the "exemption is to be granted only to benefits paid out under an arrangement which constitutes a plan."[9]

The courts, affirming the Treasury's interpretation[10] of the "plan" requirement, have identified three basic prerequisites for the existence of a plan. First, there should be an *articulation*, prior to the occurrence of the illness,[11] delineating the employer's proposed course of conduct when presented with specified contingencies.[12] Second, the employer should make a *commitment*[13] to this articulation governing payments, whether or not such commitment is legally enforceable. Finally, the employees should be given *notice*[14] that, upon the occur-

8. For discussion of the legislative background of section 105 at the time of the 1954 amendment, see Comment, *What Is A "Plan" Under Internal Revenue Code Section 105(d)?*, 28 OHIO ST. L.J. 483 (1967); Comment, *Taxation of Employee Accident and Health Plans Before and Under the 1954 Code*, 64 YALE L.J. 222 (1954).

9. S. REP. NO. 1622, 83d Cong., 2d Sess. 185 (1954). In light of the absence of legislative discussion, one can only speculate as to the motives behind the "plan" requirement. Two reasons can be articulated in support of the "plan" requirement. The first reason revolves around the notion that a prior corporate commitment to pay benefits during periods of illness or injury gives employees a sense of security. Such security is paid for partly by private enterprise and subsidized in part by the foregone taxes on the medical benefits actually paid for and received by the employees. See text accompanying notes 70-75 *infra*. Secondly, the legislature may have feared that ad hoc payments would be difficult to distinguish from disguised dividends, if indeed such a distinction may exist outside the legal superstructure of the section itself.

10. Sections 104(a)(3) and 105(b), (c), and (d) exclude from gross income certain amounts received through accident or health insurance. Section 105(e) provides that for purposes of sections 104 and 105 amounts received through an accident or health plan for employees, and amounts received from a sickness and disability fund for employees maintained under the law of a State, a Territory, or the District of Columbia, shall be treated as amounts received through accident or health insurance. In general, an accident or health plan is an arrangement for the payment of amounts to employees in the event of personal injuries or sickness. A plan may cover one or more employees, and there may be different plans for different employees or classes of employees. An accident or health plan may be either insured or noninsured, and it is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan (or a program, policy, or custom having the effect of a plan) providing for the payment of amounts to the employee in the event of personal injuries or sickness, and notice or knowledge of such plan was reasonably available to the employee. It is immaterial who makes payment of the benefits provided by the plan. For example, payment may be made by the employer, a welfare fund, a State sickness or disability benefits fund, an association of employers or employees, or by an insurance company.

Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149-50.

11. *See* notes 41-46 *infra* and accompanying text.

12. *See* text accompanying notes 16-65 *infra*.

13. *See* text accompanying notes 80-83 *infra*.

14. *See* text accompanying notes 67-79 *infra*. The court in John C. Lang, 41 T.C. 352 (1963), stated:

rence of certain injuries or illnesses, they will be reimbursed by the employer. As will be demonstrated, there is an interplay between the commitment and notice elements such that, where the commitment element is present to the extent of a legally enforceable contract, the notice element is not essential to the finding of a plan.[15]

A. The Articulation Element

The Treasury Department has elaborated on the articulation requirement by providing synonyms for the word "plan": "arrangement" or "program, policy or custom having the effect of a plan."[16] A policy is usually some expression, either oral or written, of a consciously desired future course of conduct.[17] Custom, on the other hand, is generally thought of as expressing a future course of conduct through an unexpressed course of consistent past reactions to a given set of stimuli.[18] Hence, it would appear that the Treasury is permitting not only expressions of future conduct, but also consistent prior actions to satisfy the articulation element.

The primary value of the synonyms, however, is to illustrate that the word "plan" will be liberally construed, rather than to give any concrete meaning to the term. Of more definite value is Treasury recognition that the plan need not be in writing, conceding that the minimum level of articulation is an unrecorded custom of past payments made on the occurrence of an employee's illness.[19]

As we interpret the regulation, in order for there to be a plan, the employer must commit himself to certain rules and regulations governing payment; these rules must be made known to his employees as a definite policy . . . .

Id. at 355-56.

15. *See* notes 67-79 *infra* and accompanying text. This may be because notice is generally present in an enforceable contract or because of Treasury concern with problems of proof.

16. Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149-50.

17. "Policy" is defined as:

5a: A definite course or method of action selected from among alternatives and in the light of given conditions to guide and [usually] determine present and future decisions. b(1): a specific decision or set of decisions designed to carry out such a chosen course of action.

WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1754 (3d ed. 1961).

18. In comparison to "policy," very little formalism or articulation is involved with the concept ascribed to "custom": "a form or course of action characteristically repeated under like circumstances." *Id.* at 559.

19. Even the Tax Court was at first unwilling to concede so much. In John C. Lang, 41 T.C. 352 (1963), the court appeared to require the communication to employees of a *definite policy*. *Id.* at 356. However, it was questionable that the "plan" in *Lang* would even amount to a custom. Therein, the managers in the New York corporate offices would decide on a case-by-case basis, without any established criteria, whether

Before discussing the minimum articulation problems, it is appropriate to discuss a few basic considerations dealing with conventional articulation—*i.e.*, written or oral plans. In setting up a plan, the first problem is knowing what to articulate. All heretofore acceptable plans shared two features: first, the amount that the employer will pay, and, second, the conditions that must exist before the payments will be made.[20] A simple statement that the company will pay all the medical expenses incurred by employees for themselves, their spouses, and their dependents would appear to be a sufficient articulation of a medical reimbursement plan,[21] although it is not suggested as a proper one. This plan states the amount (all), the conditions (medical expenses), and the persons for whom the expenses are incurred (employees, their spouses, and their dependents).

The conditions of the plan—that is, the events that will generate benefit payments—need not be limited to the provisions of section 105(b),[22] (c)[23] and (d),[24] although only the amounts permissible thereunder will be excludable from the employee's income.[25] For example, the articulation may include payments for cosmetic surgery although such amounts may be outside the definition of medical ex-

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employees at the various branch offices would receive their wages or salaries during illness. Thus any adverse language requiring more than a custom would be dicta. Nevertheless, since *Lang*, the exclusion for payments pursuant to a "custom" has been upheld. *See* text accompanying notes 41-64 *infra*.

20. *See, e.g.*, Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965); Andress v. United States, 198 F. Supp. 371 (N.D. Ohio 1961); Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); Arthur R. Seidel, 30 CCH Tax Ct. Mem. 1021 (1971); Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968).

21. Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965). Although *Niekamp* involved a plan established by custom, the court interpreted the custom to read: "The company merely [pays] all employees who [are] ill full salary as long as they [are] ill." *Id.* at 197.

22. Section 105 (b) provides for the exclusion from gross income of payments received for "medical expenses" as defined in section 213.

23. Section 105(c) provides for the exclusion from gross income of payments designed to compensate the taxpayer for the permanent loss of a member or function of his body.

24. Section 105(d) provides for the exclusion from gross income of sick pay to the extent that, at maximum, it does not exceed $100 per week.

25. *See, e.g.*, Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965). In *Niekamp*, the taxpayer was receiving $7,200 per year base salary plus a regular annual bonus. *Id.* at 196. When he became ill, the company continued to pay his base salary although only $5,200 per year was claimed ($100 per week times 52 weeks per year). *Id.* The $7,200 per year benefits were limited by the provisions of subsection (d) which limits the excludable salary to $100 per week in extended illnesses. The same reasoning should apply to medical benefit payments that do not qualify as section 213 medical expenses. *Accord*, Andress v. United States, 198 F. Supp. 371 (N.D. Ohio 1961).

penses in section 213[26] and, therefore, includible in the employee's gross income. Other conditions may limit the payments to specific types of medical expenses such as surgery costs or expenses relating to heart attack treatment. Conditions may be stated which limit benefits by allowing only a maximum per employee, per class of employee, or per salary of employee. Very serious problems are raised when the conditions attempt to limit the class of recipients, especially to shareholder employees. Such classifications are likely to run afoul of the statutory requirement that the plan be one "for employees."[27]

As to who must do the articulation, the case has not yet arisen where the plan was denied because the wrong person or persons articulated the plan. On the other hand, all plans considered by the courts to this date have been adopted by the authoritative body of the employer—*e.g.*, the board of directors of a corporation.[28]

Aside from the "custom" plans discussed in greater detail below, the plan may be articulated either orally or in writing.[29] Of course, a writing is preferable because it has evidentiary value for the taxpayer who has the burden of proving the existence of the plan.[30] Nevertheless, it is clear that the board of directors may orally adopt a plan without ever reducing the plan to writing.[31] However, the oral discussion must not be merely an agreement to adopt a plan, but rather must be an agreement that certain amounts will be paid to certain persons on certain contingencies. Ambiguity in the oral discussion has been

26. *See* INT. REV. CODE OF 1954, § 213.

27. *See* text accompanying notes 84-156 *infra.*

28. *See, e.g.*, Arthur R. Seidel, 30 CCH Tax Ct. Mem. 1021 (1971); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970); Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968). Note that no cases have dealt with this issue in the context of partnerships.

29. Treasury regulation section 1.105-5(a) provides, in part, that "it is not necessary that the plan be in writing . . . ." Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149.

30. Section 7453 of the Internal Revenue Code of 1954 is the legislative authorization to the Tax Court to prescribe procedural rules. Tax Court rule 142(a) establishes the burden except for in limited circumstances not including section 105:

> The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the respondent.

In refund suits conducted on the district court level, the taxpayer is required to make full payment of the assessed tax. *See* Flora v. United States, 357 U.S. 63 (1958), *aff'd on rehearing*, 362 U.S. 145 (1960). Thus, in the suit to recover a refund, the taxpayer is placed in the position of any plaintiff in a civil action being required to prove his case by a preponderance of the evidence. *See* United States v. Anderson, 269 U.S. 422, 443 (1926).

31. *See, e.g.*, Andress v. United States, 198 F. Supp. 371 (N.D. Ohio 1961).

held to be fatal.[32]

Recording the board's discussion in the minutes of the directors' meetings provides a sufficient writing. In *Alan B. Larkin*,[33] the original plan was unwritten, the only written evidence of a plan being a corporate resolution in the minutes "to continue the accident and health plan for such employees that the officers at their discretion consider should be covered."[34] Aside from management's retention of discretion and their failure to notify employees, it appears that the lack of a properly defined *original* plan led the court to describe the plan as "extremely tenuous."[35] Nevertheless, the court did not defeat the taxpayer on the "plan" criteria.[36] In *Bogene, Inc.*,[37] an oral resolution, recorded in the corporate minutes, that "Bogene, Inc. shall pay all medical expenses incurred by Mr. J. S. Bowman for himself, his wife and his children for the year 1962 and henceforth"[38] was sufficient. The court noted that "[i]t is clear that a 'plan,' as defined in the regulations, existed . . . ."[39] Notwithstanding this leeway, the preferred method of evidencing the plan is to incorporate into the corporate minutes by reference a separate document entitled "Medical Reimbursement Plan" or "Wage Continuation Plan."[40] Such planning would permit a detailed tailoring of the plan to the needs of the employees and the financial position of the employer.

With regard to the appropriate time for articulating the plan, regulation section 1.105-5(a) requires that the plan be adopted prior to the occurrence of any illness for which payment is made.[41] Section 1.105-

32. In Arthur J. Seidel, 30 CCH Tax Ct. Mem. 1021, 1025 (1971), an agreement to create a plan was held invalid. The statement should have been an articulation of the plan itself.

33. 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968).

34. *Id.* at 631.

35. *Id.* at 633.

36. *Id.* at 635. Rather, the court found against the taxpayer on the "for employees" issue. *Id.* (*see* text accompanying notes 118-22 *infra*).

37. 27 CCH Tax Ct. Mem. 730 (1968).

38. *Id.* at 732.

39. *Id.* at 733.

40. The permissibility of incorporation by reference is indicated by the language of the court in Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968), wherein the court commented on the plan described in the minutes: "Although the plan was not in writing, the resolution adopted by the Board of Directors was reported in the corporate minutes." *Id.* at 733. *See also* O'Connel, *Accident and Health Plans Offer Many Tax Benefits: A Guide on Setting Them Up, Requirements, Rules*, 2 TAXATION FOR ACCOUNTANTS 54 (1967).

41. Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149 provides in part:

[I]f the employee's rights are not enforceable, an amount will be deemed to be re-

5(a) is no doubt justified by the statutory requirement that the payment be made pursuant to a plan.[42] This requirement has been recently affirmed by the Tax Court in *American Foundry*,[43] invalidating a "plan" to continue the salary of a corporate president because the measure was passed after the president became ill.[44] In *Nathan Epstein*,[45] the Tax Court placed strong emphasis on the fact that the participants were in reasonably good health at the time the plan was adopted.[46]

If no oral or written plan exists because of the absence of careful forethought, a taxpayer might attempt to establish the existence of a plan in the form of a "custom." A plan, however, is exposed to risks when the degree of articulation devolves into this lower level of "customary" payments. One risk is determining at what point a custom has come into existence. This is crucial because payments prior to that time will not be deemed pursuant to the "plan." This determination is a function of the length of time that the "custom" has been in effect and the number of times payments were made prior to the attacked payments.[47] The first payments made are unsupported by a prior history and are more likely to be included in the employee's gross income; whereas, the exclusion of payments to employees subsequently ill is based on the previous payments. The case authority delineating when successive repetition of employer payments becomes a sufficient custom to satisfy the articulation requirement leaves a gray area still unchartered.

In *Barron v. United States*,[48] for example, a wage continuation plan was held to exist where there had been a "long standing and unwritten policy or custom of continuing to pay the salary of a salaried

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ceived under a plan only if, *on the date the employee became sick or injured*, the employee was covered by a plan . . . .

(Emphasis added).

42. Section 105(e)(1) provides in part: "amounts received *under* an accident or health plan . . . ." INT. REV. CODE OF 1954, § 105(e)(1) (emphasis added).

43. 59 T.C. 231 (1972).

44. *Id.* at 239.

45. 31 CCH Tax Ct. Mem. 217 (1972).

46. *Id.* at 221. In Timothy L. Pickle, Jr., 30 CCH Tax Ct. Mem. 1300 (1971), the court noted that "[t]o prevail, petitioner must establish not only that a valid wage continuation plan existed but also *that the plan was in effect prior to his illness*." *Id.* at 1302 (emphasis added).

47. Note that even where there has been only an oral articulation of the plan, this risk is not as prevalent. For example, in Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972), the court noted that an oral adoption of the plan was sufficient; it did not analyze the amount and number of payments made. *Id.* at 220. An "oral" plan, however, must be in operative language.

48. 17 Am. Fed. Tax R.2d 334 (W.D. Pa. 1966).

employee during absences from work because of illness."[49] No time period was mentioned. A plan was similarly held to be sufficiently articulated in *Niekamp v. United States*,[50] wherein a steel warehousing corporation had an unwritten custom or policy of "retaining the service of elderly administrative and executive employees on the job as long as they were able to work . . . [and] to pay all administrative and executive personnel their full salary during periods of illness"[51] from 1925 to 1959—a period of thirty-four years.[52] In commenting on the articulation element, the *Niekamp* court noted that "the company policy was clear, simple and not ambiguous. The company merely paid all employees who were ill full salary as long as they were ill."[53]

In contrast, the Tax Court in *Estate of Kaufman*[54] held that a wage continuation plan was insufficiently articulated by custom where there was no evidence of any specific instance where payments were made to previously sick employees, other than the taxpayer who, before his stroke, was the managing officer of the business.[55] Similarly, in *Rosario Occhipinti*,[56] the Tax Court held that the articulation element was not satisfied:

> There is no evidence that the terms of [the taxpayer's] employment arrangement entitled him to these benefits or, indeed, that any other employee ever received such a benefit. The record shows merely that [the taxpayer], an officer and major stockholder of the corporation, continued to receive his salary during his illness.[57]

Hence, thirty-four years and substantial payments may satisfy the articulation element, whereas a single payment will probably not be sufficient to establish a "custom." This leaves fertile ground for advocacy, but the very opportunity is indicative of someone's poor planning.[58]

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49. *Id.* at 335.
50. 240 F. Supp. 195 (E.D. Mo. 1965).
51. *Id.* at 197.
52. *Id.*
53. *Id.*
54. 35 T.C. 663 (1961), *aff'd*, 300 F.2d 128 (6th Cir. 1962).
55. *Id.* In *Kaufman*, the court found it significant that the only other instance of "customary" payment under the alleged plan was to an employee *after* the decedent's stroke. *Id.* at 667. This again points out the tax risk of being the first one sick under such a plan. In Rosario Occhipinti, 28 CCH Tax Ct. Mem. 978, 982 (1969), the Tax Court relied on the lack of evidence of prior payments to any other employee to defeat the alleged "custom."
56. 28 CCH Tax Ct. Mem. 978 (1969).
57. *Id.* at 982.
58. *Cf.* Edward A. Bernstein, 20 CCH Tax Ct. Mem. 804 (1961).

For those "custom" plans already in operation, it is not too late to correct the ambiguity by reducing the plan to writing and gaining its retroactive effect. For example, in *E. B. Smith*,[59] the corporation began paying all the officer's medical expenses in 1963 on the advice of an accountant. It was not until the last day in 1966 that a written plan was adopted. The corporate resolution specifically provided for a ratification of the prior payments.[60] The court held that a plan existed for 1965 *according to the terms of the resolution.*[61]

An additional risk confronting the custom plan is the difficulty of determining its scope with precision. For example, where the history of payments reveals a reasonable relation to the productivity of the employee, the expression and commitment of the employer may be limited to those payments that bear a similar relationship. Thus, any payment that varies in size or purpose may not be established by custom.[62] This appears to have been the suggestion of the Tax Court in *Chism Ice Cream Co.*[63] There, the employer had a history of seven payments to employees; five were for less than $900 each, and the other two totalled less than $5,000. By contrast, Mr. Chism's salary of $120,000 was continued during the five year period of disability preceding his death. The court held that the seven payments were insufficient to establish a custom plan, but the real import was that even if the plan existed, its scope would not have encompassed the disproportionately large payments to Mr. Chism.[64]

On the other hand, custom may complement a written plan which would otherwise have failed. For example, in *Bogene, Inc.*,[65] the plan was worded to cover Mr. Bowman, his wife and his chil-

59. 29 CCH Tax Ct. Mem. 1065 (1970).

60. *Id.* at 1066.

61. *Id.* at 1067; *accord*, Timothy L. Pickle, Jr., 30 CCH Tax Ct. Mem. 1300, 1303 (1971) (holding that a board resolution, occurring two years after a sick pay custom-type plan had been in existence, "merely put into writing a pre-existing plan"); *cf.* Charlie Sturgill Motor Co., 32 CCH Tax Ct. Mem. 1336, 1348 (1973).

62. This risk was directly encountered and overcome in Timothy L. Pickle, Jr., 30 CCH Tax Ct. Mem. 1300 (1971), wherein the custom-type plan had only been in effect for less than two years and had only continued the salary of an employee at most for five weeks prior to the permanent disability incurred by the president (also the 50% shareholder). His salary was continued for 6 months at the full rate and at a reduced rate thereafter. *Id.* at 1301. The court noted that, although the plan had never paid out so much in its short two year history to an employee, the size of the payment to the president did not negate the existence of the plan but rather was a factor in determining the amount deductible. *Id.* at 1302-03.

63. 21 CCH Tax Ct. Mem. 25 (1962).

64. *Id.* at 29.

65. 27 CCH Tax Ct. Mem. 730 (1968).

dren, whereas Mr. Hochfelder's wife and children were not expressly included. Nevertheless, the plan was construed to include Hochfelder's family because the past payments to Hochfelder were on account of his family's illness, thereby expanding the scope of the written plan by custom.[66]

B. The Commitment and Notice Elements

The courts and the Treasury have recognized that the commitment and notice requirements are interdependent.[67] There is a trade-off in the quantum of each that may exist. As will be shown, it may be best to view these elements as in a state of dynamic equilibrium. Specifically, the trade-off is between the requirements that the employer commit himself to a course of action and that he give notice to the employees receiving the benefit. The regulations do not interpret section 105 as requiring a legally enforceable promise by the employer to pay for certain employee's illnesses.[68] Hence, the degree to which the employer is required to *commit* himself to the formulation of the plan (the commitment element) is something less than a legally enforceable contract. If the employee's rights are not legally enforceable, "an amount will be deemed to be received under a plan only if, on the date the employee became sick or injured, the employee was covered by a plan . . . *and notice or knowledge of such a plan was reasonably available to the employee.*"[69]

The regulations, establishing the interrelation between commitment and notice, state two combinations of these elements that will pass muster. First, if there is a contractually valid commitment, no notice is necessary.[70] Second, if there is less than a contractually valid commitment, the notice element must be "reasonably available." Outside of these two situations, the degree to which other combinations are acceptable will have to be defined by the courts.

Whereas the commitment element arises from a plain meaning interpretation of the word "plan,"[71] the notice element, imposed by the

66. *Id.* at 733.

67. *See* Barron v. United States, 17 Am. Fed. Tax R.2d 334 (W.D. Pa. 1966); Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965).

68. Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149 provides in part:

> [I]t is not necessary that the plan be in writing or that the employee's rights to benefits under the plan be enforceable. However, if the employee's rights are not enforceable, an amount will be deemed to be received under a plan only if . . . notice or knowledge of such plan was reasonably available to the employee.

69. *Id.* (emphasis added).

70. *Id.*

71. See text accompanying notes 80-83 *infra.*

Treasury and reaffirmed by the courts, has a somewhat ambiguous origin and purpose. Ascertaining the purpose of the notice element is of paramount importance if courts are to properly define the elements of section 105 plans. Two reasons may be postulated for the imposition of the notice requirement.

First, its purpose may be merely evidentiary. That is, although the Treasury was willing to permit a less-than-legally enforceable (noncontractual) commitment, it would not tolerate "secret" commitments which come dangerously close to being no commitment at all. The act of giving notice to the employees would serve as proof of the employer's commitment to the plan. Nevertheless, the Treasury recognized that exclusion should not depend on the completion of the communication process and proof would have been just as satisfactory if a reasonable person could have acquired knowledge of the plan. Therefore, the Treasury only required that knowledge of the plan be reasonably available to the employees covered.

Under this interpretation, the notice element has no significance independent of the commitment element and serves only as evidence of the sufficiency of the employer's commitment.[72] If this is the case, the courts should develop criteria that emphasize the extent to which the employer demonstrated a commitment to the plan and deemphasize notification of the employees covered (although such attempted notification might be taken into consideration). A history of appropriate payments might satisfy this new test even though a sick employee is totally surprised upon receipt of the check and even though there has been no attempt to "advertise" the plan.

An alternative explanation for imposing the notice requirement is to

72. There is some doubt as to whether or not the Treasury is exceeding the scope of its statutory duty by imposing evidentiary standards. Section 7805(a) provides the general authorization to the Treasury:

> [T]he Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

INT. REV. CODE OF 1954, § 7805(a). The prescription of legislative regulations would be clearly within the bounds of the Treasury's statutory duty, as would be interpretative regulations. However, it seems that the establishing of criteria by which some fact (here, the commitment of the employer to make the payments) must be proved falls in the borderline area of rules "needful . . . for the enforcement of this title." *Id.* Furthermore, the Code specifically provides that evidentiary matters are to be governed by established rules of evidence existing in the United States District Court of the District of Columbia. *See* INT. REV. CODE OF 1954, § 7453. The same section specifically disenfranchises the Tax Court from establishing rules of evidence, although it is given the authority to establish other rules of practice and procedure. This would seem to be an expression of legislative intent that matters of evidentiary standards are not within the province of the Treasury.

increase the employees' sense of security. The Treasury may have recognized a two-fold purpose of section 105 of the Code: first, to upgrade the distribution of medical services, and, second, to impart a sense of security to employees under such plans.[73] This latter objective can best be met by requiring the employer to do his best to communicate to his employees that they are covered by the plan. Under this interpretation, the courts should develop criteria to measure the employer's effort in communicating the plan. But if this is the proper interpretation, why not require actual knowledge? Probably because the employer would be less reluctant to assume the risk of nondeductibility should the communication be unsuccessful—an event outside of his control. Although alternate avenues for deductibility may be possible,[74] payments pursuant to a medical benefit plan have been held expressly deductible under section 162 and the regulations thereunder.[75]

But if this second interpretation is the proper one, why dispense with the notice requirement in the contractually binding plan? Inasmuch as expectancy (notice) is generally an integral part of legally enforceable contracts,[76] it would be redundant to further require the employee to have notice in the case of legally enforceable plans. The regulations have demanded less than legal enforceability as the standard for the commitment element, while seemingly preserving one of its by-products—the expectancy in the employees.

The specificity of the notice requirement will vary materially depending upon the theory ultimately adopted by the courts. If the

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73. John C. Lang, 41 T.C. 352 (1963). While this is the court speaking, and not the Treasury, it typifies the possible reasoning of the Treasury. This court, in defeating a highly discretionary commitment to continue salaries during employee illnesses, noted "[t]he 'general practice' of Aaron [the employer] offered no definite *expectation* to petitioner or to any other employee that he would receive continued salary if he became sick." *Id.* at 357 (emphasis added).

74. *See* notes 159-60 *infra* and accompanying text.

75. INT. REV. CODE OF 1954, § 162 provides in part:

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered . . . .

Treas. Reg. § 1.162-10(a) (1958) provides in part:

Amounts paid or accrued within the taxable year for . . . sickness, accident, hospitalization, medical expense . . . or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.

76. Corbin summarizes his concept of the purpose of contract law as follows:

That portion of the field of law that is classified and described as the law of contracts attempts the realization of reasonable expectations that have been induced by the making of a promise.

1 CORBIN ON CONTRACTS § 1 (1963).

purpose of the notice requirement is "security," the courts should require a higher standard for judging the existence and satisfaction of the notice element, perhaps even to the point of requiring actual notice.[77] On the other hand, if the purpose is "evidentiary," courts should permit a less stringent standard for judging notice and should allow alternate methods of proving the employer's commitment to the plan.

Regardless of the elusive purpose behind the notice requirement, it appears that, when notice is required, the notice need only be reasonably directed toward employees eligible under the plan.[78] Furthermore, there is a tendency to require that their knowledge be more than an unsubstantiated rumor; the employee should genuinely expect that in case of illness the employer would make payments consistent with his prior articulation.[79]

From the fact that articulation and commitment are presented herein as separate elements, it may be gathered that commitment is something more than merely formulating and expressing an intent to make payments related to an employee's personal injury or sickness. For example, in *John C. Lang*,[80] the employer had a "general practice" of continuing the pay of salaried employees conditioned on approval by a committee at the home office. Noting that the committee had no pre-established criteria for awarding payments, the court rejected the plan primarily because there was no prior commitment to the payment of section 105 benefits.[81] Rather, the discretion to make such pay-

77. In dicta, various courts have appeared to require actual notice. *See* Estate of Chism, 322 F.2d 956, 961 (9th Cir. 1963) (stressed lack of *formal* notification); Niekamp v. United States, 240 F. Supp. 195, 197 (E.D. Mo. 1965); Jack M. Burr, 25 CCH Tax Ct. Mem. 592, 603 (1966); John C. Lang, 41 T.C. 352, 356 (1963) ("these rules *must* be made known to his employees"). *But cf.* Barron v. United States, 17 Am. Fed. Tax R.2d 334 (W.D. Pa. 1966) (giving recognition to "availability" standard of notice without citing authority); Nathan Epstein, 31 CCH Tax Ct. Mem. 217, 220 (1972) (interpreting the regulations directly to require that the members only have "reasonable notice or knowledge that they are covered by the plan").

78. In Niekamp v. United States, 240 F. Supp. 195 (E.D. Mo. 1965), the steel warehouse company probably had several hundred employees, most of whom were probably unaware of the plan. But inasmuch as the custom-established plan was designed to cover administrative and executive personnel, it was only necessary that all the administrative and executive personnel had knowledge. *Id.* at 197.

79. Estate of Chism, 322 F.2d 956, 961 (9th Cir. 1963).

80. 41 T.C. 352 (1963).

81. *Id.* at 357. Note that the validity of the *Larkin* plan (see text accompanying notes 33-36 *supra*) could have been decided on the lack of commitment element, but because there appeared to be a semblance of commitment once the board of directors chose the employee, the court probably avoided the issue and decided the

ments had at all times been retained by the corporate management.[82] Hence, the quantum of the commitment must at least be such as to remove from the corporation the discretion to make the benefit payment after the injury has occurred. The existence of some standards of payment—some criteria—is essential. Nevertheless, this requirement should not preclude subsequent review of claims. It seems reasonable that if in articulating the plan the employer has classified only certain types of injuries or illnesses as compensable, the employer should be allowed to organize a committee to evaluate whether a claim is within the scope of injuries or illnesses compensated under the plan.[83]

II. For Employees

Not only must a health and accident plan exist, but it must also be "for employees." Had the House version of section 105 passed, it would have been necessary that the plan be non-discriminatory.[84] Basically, this would have precluded a health plan covering only limited groups of persons.[85] However, the Senate Finance Committee proposed that the non-discriminatory provision be eliminated:[86]

> The qualification rules provided in the House bill have been eliminated. This was necessary because your committee, for reasons developed in the discussion on pensions, stock-bonus and profit-sharing plans, abandoned the automatic qualification rules provided by the House bill. Without these rules it would be necessary in most cases to obtain specific rulings from the Internal Revenue Service in the case of each employer sickness and accident plan, if the requirement had

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case on the more egregious violation of the section—the "for employees" provision. 48 T.C. at 635. *See also* notes 118-22 *infra* and accompanying text.

82. 41 T.C. at 353. One persuasive piece of evidence contributing to the Tax Court's determination that no established criteria existed was the fact that Lang's assistant (Lang being the branch office sales manager of a machinery company), who assumed Lang's full duties during the latter's three month absence, became ill as Lang was recovering. The committee at first refused to continue the assistant's pay, but at the continued beckoning of Lang, payments were made. *Id.* at 354. Thus while the two men performed the same service for the corporation, only one would have benefited, absent Lang's interference.

83. *See* text accompanying note 20 *supra.*

84. *See* H.R. 8300, 83d Cong., 2d Sess. § 105(c)(1) (1954).

85. *See* H.R. Rep. No. 1337, 83d Cong., 2d Sess. 15 (1954). The plan was required to meet the specific employee coverage, contribution, and benefits payable tests similar to those currently noted in section 501 covering pension plans. The House version further required legal enforceability such that any covered employee have a non-forfeitable right to the benefits under the plan.

86. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 15 (1954).

been kept that they must be qualified to receive the treatment described above.[87]

This proposal was accepted by both the Senate and the Conference Committee. This language provided powerful ammunition for subsequent litigants arguing that a plan may discriminate in favor of certain employees, such as shareholder-employees.[88] Ultimately, the Senate version did impose a restriction—the plan must be "for employees."[89]

The Treasury Department has interpreted the "for employees" requirement as permitting the plan to cover even a single employee: "A plan may cover one or more employees, and there may be different plans for different employees or classes of employees."[90] However, it is decisional law that has given form to this requirement. The issue has arisen mostly in the context of closely-held corporations which adopted plans covering shareholders. Surprisingly, no cases on the subject matter arose in the first thirteen years following the enactment of section 105. By contrast, the last seven years has seen this phrase seized upon by the Treasury to the doom of many health and accident benefit plans.[91]

Basically, case authority has established that, in order to be "for employees," the plan must have been created with the intent that the designated participants, regardless of their equity interest in the corporation, receive the benefits as a consequence of their relationship to the corporation as employees and not as a consequence of some other relationship to the corporation, *e.g.*, as a shareholder or relative of one. The Tax Court in *Alan B. Larkin*[92] established the criterion for determining whether or not a plan is for employees: "The touchstone of section 105(b) is that the *genesis* of a medical benefits

87. *Id.* at 16.

88. *See* text accompanying notes 118-22 *infra.*

89. Halting the use of freely discriminatory plans, the *Larkin* court expressed the view that:

> The frequent use of the word "employee" in section 105 itself, and in the Committee reports, clearly reveals that the purpose of Congress in enacting the section was to benefit employees as distinguished from other classes of persons.

48 T.C. at 633.

90. Treas. Reg. § 1.105-5(a), T.D. 6722, 1964-1 CUM. BULL. 149-50.

91. *See* Charlie Sturgill Motor Co., 32 CCH Tax Ct. Mem. 1336 (1973); American Foundry, 59 T.C. 231 (1972); Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); Arthur R. Seidel, 30 CCH Tax Ct. Mem. 1021 (1971); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970); Edward D. Smithback, 28 CCH Tax Ct. Mem. 709 (1969); Samuel Levine, 50 T.C. 422 (1968); Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968); Alan B. Larkin, 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968).

92. 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968).

plan must be a *purpose* to benefit 'employees' as against other persons or classes of persons."[93]

Larkin, as the first case giving legal significance to the words "for employees," has been consistently followed.[94] The court's requirement of intent is the crucial common denominator upon which all the decisions dealing with the "for employees" issue may be reconciled. The key to analysis of cases will be the purpose of the drafters when formulating the plan. The "intent facts"[95] that have been cited by cases to date are analyzed below. Recognizing that future cases may satisfy this element with "intent facts" not heretofore employed,[96] this analysis will be fruitful to planners in that they may avoid the recognized dangers by structuring the transaction with facts that have previously survived judicial scrutiny.

A. The Correlation Between the Asserted Benefit Received from the Covered Employee-shareholder and the Omission from the Plan of Similarly Useful Personnel

One primary test to determine whether or not the participants have received the benefits as a consequence of their shareholder interest is to note the reasons advanced to support the benefits.[97] Many plans specify that the recipients contribute key management skills;[98] in such cases the court determines whether all persons similarly productive to the corporation, key management in particular, are also covered

93. *Id.* at 635 (emphasis added).

94. For *Larkin* and its progeny on the "for employees" issue, see note 91 *supra.*

95. 48 T.C. at 635. The *Larkin* case refers to such facts as "indications of purpose." *Id.* They will herein be referred to as "intent facts."

96. *See, e.g.,* Samuel Levine, 50 T.C. 422 (1968). In *Levine,* Judge Raum, in somewhat of a "maverick" opinion, recognized the financially troubled corporation could not have had the economic bad sense to have intended to tie the health of the company to the health of its president. Theretofore, no such fact would have been expected to defeat the plan on the issue of "for employees." *Id.* at 427.

97. Sometimes the court is willing to find certain implications regarding purpose when the "plan" fails to so state. For example, in Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968), the plan of a garment bag manufacturing corporation, owned by two 50% shareholder-officers and employing approximately 50 lesser employees, was worded simply to pay all the medical expenses of the two officers. *Id.* at 733. The court assumed "the underlying purpose of this plan was to provide extra medical benefits to the two key management employees . . . ." *Id.*

98. *See, e.g.,* Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970). For an example of a plan in which the motive for payment was not expressly stated, but was implied by the parties and so construed by the courts, see note 97 *supra.*

by the plan.[99] If there is a high correlation between those within the productivity group and those covered by the plan, it is an indication that the drafters intended such persons to be compensated for their productivity.[100] A low correlation evinces a design to benefit the recipients for a reason other than their asserted value to the corporation. Moreover, if there is a high correlation between the members of the "underinclusive" plan and the shareholders of the corporation, it is further indication of the drafters' intent that the recipients receive their benefits as a function of their equity interest in the corporation[101]—the common characteristic of a dividend.[102]

It is crucial to note that this intent fact by no means prevents a plan covering only shareholding employees.[103] The issue is purely factual: whether the intent was that the shareholder-employee receive benefits because of his shareholder interest, or because of his uniquely productive services to the corporation.[104] This distinction appears to have been blurred by the Tax Court's decision in *American Foundry*;[105] however, careful analysis reveals that the decision does not preclude the shareholder-employee plan. In *American Foundry*, the corporate employer, who was also the taxpayer, adopted a plan surreptitiously designed to benefit one person who was both the president of the corporation and co-owner (with his wife) of the largest block of shares (80%).[106] The court recognized that although the president, Domenic, made substantial contributions to the success of the company, his utility

99. For example, one factor that contributed to the failure of the *Larkin* plan was the fact that the father of two 50% shareholder-brothers was paid $1,196 per year, representing a relatively low level of productivity to the corporation. Nevertheless, under the plan it appeared that he was entitled to the same benefits as his two sons, whereas Pluznick, a valued non-shareholder employee receiving a substantially greater salary than the father, was not entitled to free Blue Cross coverage. 48 T.C. at 633-34.

100. See text accompanying notes 110-17 *infra*. In *Larkin*, the court, while expounding on the "for employee" issue, noted that "[t]here is no indication . . . that the payment of medical benefits was in any way related to the performance of services by employees of the corporation." 48 T.C. at 633.

101. See note 99 *supra*.

102. *See, e.g.*, Chism Ice Cream Co., 21 CCH Tax Ct. Mem. 25, 31 (1962).

103. See text accompanying notes 121-22 *infra*.

104. See note 100 *supra*.

105. 59 T.C. 231 (1972).

106. *Id.* at 234. The plan was worded as follows: "Be it resolved: that officers . . . to the extent not covered by existing insurance that medical expenses be payed by the corporation . . . ." *Id.* Shortly before the adoption of the plan, the other ten officers of the corporation had purchased a group insurance policy. It was the understanding that the plan was intended solely for the benefit of the president. The court interpreted the plan as a device to reimburse Domenic Meaglia for his medical expenses. *Id.* at 242.

was not significantly beyond that of other officers similarly situated.[107] The court noted that "there were a number of other officer-employees who also served the corporation in similar capacities, sometimes even filling in for Domenic for extended periods, who were not covered by the plan."[108] Domenic's daughter had replaced him for extended periods of time while he had been on vacation (prior to the occurrence of his heart attack). The fact that Domenic was replaceable and had been replaced on several occasions negated the establishment of the requisite intent—that Domenic receive the benefits solely as a function of his employment, and not of his stock interest.

American Foundry does not stand for the proposition that a plan may not cover one employee who is also the sole shareholder. The court will still look to the relative productivity of that employee as compared to the other employees' productivity as an indication that, if similarly productive employees are omitted, there is or is not a "rational basis" for distinguishing between them. Thus, *American Foundry* is clearly consistent with previous cases upholding plans notwithstanding the fact that the only employees covered were also shareholders.[109]

In *Nathan Epstein*, the Tax Court held the corporation's plan to pay all medical expenses of the four corporate officers and their dependents to be "for employees" even though the plan did not cover other non-officer employees and even though the four officers covered were the corporation's only shareholders.[110] The asserted benefit received by the corporation was the greater productivity an officer of a corporation provides over non-officers.[111] Since the plan covered all corporate officers, there was a 100% correlation between the the persons conferring the benefit to the corporation and the persons covered by the plan. As the court noted:

> The four officers composed a separate group within the Corporation with respect to duties as well as remuneration. Each was essentially a buyer and seller of used machinery and each was a keyman to the success of the Corporation. None of the other employees served in such a position. It is our view that [the four officers] formed

107. *Id.* at 242.
108. *Id.*
109. *See, e.g.*, Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970).
110. 31 CCH Tax Ct. Mem. at 221.
111. *Id.*

> a class of employees which could be rationally segregated from the other employees on a criterion other than being shareholders of the Corporation.[112]

In a similar situation, the Tax Court, in *E.B. Smith*,[113] held that the plan was "for employees" where, of fourteen employees, the only two employees covered were the officers of the corporation who were the only shareholders.[114] Of the twelve excluded employees, only one, a warehouseman, had been in the service of the corporation for more than a year (three years). The longest service of the remaining eleven employees was four months.[115] Again, the asserted benefit received by the corporation from the covered officer-employees was the utility of management services to the corporation. And once again, the court recognized that there was a 100% correlation between the persons conferring the benefit (key management services) and the persons covered by the plan. The Tax Court stated that "[t]here were no other employees who performed duties that were similar to those performed for the Corporation by the . . . [two officers] but who were excluded from the plan."[116] Thus, considering the nature of the services of the non-covered employees, the class denoted as "officers" provided a natural basis to justify the exclusion of less essential employees from the plan.[117]

This intent fact presents the single greatest difficulty to the planner whose objective is to select only shareholders. The problem arises because the tax planner cannot "make" one employee less productive than his shareholding comrade. However, through careful drafting, one can accomplish coverage of shareholders by choosing a common denominator (*e.g.*, key management, salesmanship, or manufacturing-organizational skills), which tends to select the shareholder-employees to the exclusion of non-shareholder-employees.

All cases to date have dealt with corporate plans for "key management." This amorphous term makes the employee's exceptional productivity to the corporation the common denominator. This being theoretically reduceable to a revenue-generating capacity, the plan's success depends on the extent of the "spread" between the

112. *Id.*
113. 29 CCH Tax Ct. Mem. 1065 (1970).
114. *Id.* at 1067.
115. *Id.* at 1065-66.
116. *Id.* at 1067.
117. The *Smith* court used the phrase "natural category" to express this concept. *Id.* *Accord,* Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968).

dollars produced by the covered employees and that produced by non-covered employees. However, if the drafters of the plan assert as a benefit received some more specifically productive value than "key management services," the test for the success of the plan would be evaluated by comparing the spread between the dollars produced by the covered employees within that specific aspect of the business and the productivity of the non-covered employees in the *same aspect of the business.* For example, if the plan was genuinely designed to compensate Mr. Salesman (who is also the sole shareholder) for being a good salesman, the success of the plan should depend on whether there are other salesmen in the corporation who are similarly "good," not on the fact that the excluded manufacturing department vice-president generates more revenue for the corporation. The fact that Mr. Salesman was also the sole shareholder and president of the corporation should not change the standards for decision-making if the plan was genuinely intended to compensate him for the asserted specific productivity.

B. Equality of Treatment Between Shareholder Members of the Plan and Non-shareholder Members of the Plan

If a plan is designed to compensate the participants as a consequence of their employment and not their shareholder interest, both shareholder and non-shareholder members should be treated equally. Any inequality not reasonably related to the productivity of the member may be fatal to the exclusion of benefits from gross income pursuant to section 105. For example, in *Alan B. Larkin,*[118] of the plan's four covered employees, three were shareholders or relatives of shareholders, and the fourth, Pluznick, was a highly valued employee who qualified under the provisions of the plan which included "such employees that the officers at their discretion consider should be covered."[119] The corporation paid the premiums on the Blue Cross Insurance for the three shareholder participants but failed to make such premium payments for the fourth non-shareholder participant, Pluznick. This inequality between shareholders and non-shareholders created a doubt significant enough to lead the court to conclude that the plan was intended to benefit the participants solely as a function of their equity interests, and not of their employment:

118. 48 T.C. 629 (1967), *aff'd,* 394 F.2d 494 (1st Cir. 1968).
119. *Id.* at 631.

> We do think it significant in our search for purpose, however, that, whereas Blue Cross payments were made throughout the period in question for the benefit of the stockholders and their relatives, no such payments were made for the benefit of [the non-shareholder, Pluznick]. This element . . . tends to negate the purpose to benefit employees.[120]

Larkin should not be interpreted as preventing the inequality of treatment between shareholders and non-shareholder members of the plan which may result from their disparate levels of productivity; inequality of treatment is only fatal if based on the equity interest of certain members of the plan.[121] Thus, a plan which limits the maximum medical benefits paid pursuant thereto to a fixed percentage of the employee's salary in any one year or on the basis of the number of years the employee has served the corporation should lend credence to the ultimate fact that the purpose of the plan was to benefit the recipients as a function of their employment rather than their shareholder interest. The fact that such a provision would naturally tend to favor the shareholder-employees of the small corporation should not bear on the success of the plan unless it is otherwise shown that the limiting provision was specifically included with the intent of selecting only shareholders.[122] Otherwise the very inclusion of such a provision would indicate that the genesis of the plan was with the purpose of compensating for productivity and not for some equity interest.

C. Relation of Benefits Received by Participants to Their Equity Interest in the Corporation

Another indication that the plan was designed to benefit recipients as a function of their employment and not as a function of some other relationship to the corporation is the fact that the amounts receivable by the shareholder-participants are unrelated to their equity interests. This intent fact is given greater significance where the only

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120. The *Larkin* court was also persuaded by the fact that, while the plan covered dependents of shareholders, no evidence was produced to show that Pluznick, the only non-shareholder member, had dependents who were also covered. *Id.*

121. The *Larkin* case itself notes that equal coverage for differentially productive employees was an intent fact leading to the inclusion of payments in income. Presumably, it would have been satisfied by the converse. *Id.*

122. Such an apparent intent contributed to the fatality of the *Smithback* plan, wherein the sole proprietor was advised that he could effectively select himself by limiting the benefits to "full time salaried employees." 28 CCH Tax Ct. Mem. at 710; *see* notes 147-51 *infra* and accompanying text.

employees covered are shareholders. In such a context, if the benefit payments bear a direct proportional relationship to the recipient's equity interest, it appears that the payments are in the nature of dividends rather than sick-pay benefits.

Nathan Epstein[123] serves as an illustration of this intent factor. There, the corporation's four shareholders were the only employees eligible to receive benefits under the plan.[124] One reason why the court found the plan to be designed to benefit recipients as a consequence of their employment relationship, in contradistinction to their stockholder relationship, was that the plan covered all the officer-shareholders equally, despite the fact that the equity interests of the recipients varied as follows: Irving, the father, owned 7½%; Joseph, the first son, owned 40%; Nathan, the second son, owned 27½%; and Herbert, the third son, owned 25%.[125] The court recognized that the plan provided the greatest compensation to the father because he was the eldest and thus most likely to need the benefits:

> Although each was in good health at the time the plan was adopted, it was only reasonable to assume that Irving Epstein, being the oldest, might benefit the most from the plan. Irving held the smallest number of shares of any officer but received the largest amount of medical benefit payments from the Corporation.[126]

Thus, there was a disproportion between the amounts likely to be received by the shareholder-participants and their equity interests.

The Tax Court in *Arthur R. Seidel*[127] further recognized that a disproportion between the benefits likely to be received by shareholder-participants and their shareholder interest negated the contention that the plan was intended to benefit the recipients as a consequence of their shareholder interests. In *Seidel*, a corporation adopted a plan for its two 50% shareholder-employees after one of them had suffered a severe heart attack and his daughter contracted polio.[128] The court noted that in light of these known illnesses, it was likely that the sick shareholder would incur greater medical expenses than the medically fit shareholder.[129] As such, the plan would not be benefiting the shareholders in proportion to their interest in the corporation:

123. 31 CCH Tax Ct. Mem. 217 (1972).
124. *Id.* at 218-19.
125. *Id.* at 218.
126. *Id.* at 221.
127. 30 CCH Tax Ct. Mem. 1021 (1971).
128. *Id.* at 1022-23.
129. *Id.* at 1026.

> In view of Mr. Kirchmayer's prior heart attack and the illness of his daughter, he and Mr. Seidel must have realized, when they adopted the plan, that Mr. Kirchmayer was likely to derive substantially greater benefits under the plan; hence, the adoption of the plan would not provide benefits for them in proportion to their stockholdings in the corporation.[130]

Epstein and *Seidel* convincingly indicate that a plan limited to shareholders must avoid tying the benefits to equity interests. For example, a provision limiting the maximum payable to 10% of the recipient's equity interest would ruin the taxpayer's chances for exclusion. A history of actual payments that bore a close relation to the equity employees' respective equity interests would be perhaps less drastic, but probably similarly fatal. On the other hand, where reasonably expected payments under the plan would accrue more to one 50% shareholder than to the other, the disproportion is indicative of an intent not to reward the recipient as a consequence of his equity interest in the corporation.

D. The Capacity to Absorb Unlimited Medical Expenses

The likelihood of a corporation's decision to tie its financial success to the health of its employees is another indicator of corporate intent to benefit the recipients in their capacity as employees as opposed to their capacity as shareholders. For example, in *Samuel Levine*,[131] the taxpayer owned 83/96ths of the outstanding stock of Selco, his corporation-employer, the balance being owned by his two sons. Selco had only six to eight full-time employees. According to the corporate tax returns for the prior three years, it was netting $300 to $1000 profit per year. The court held that a small, low-income company could not have contended that a plan to continue indefinitely the wage of a sick employee was in fact intended and designed for the benefit of the eight non-shareholder employees as opposed to the three shareholder employees.[132] As the court noted:

> [I]t is utterly incredible in view of its limited income and other circumstances that it would have undertaken the comparatively staggering financial burden of continuing to pay wages to its employees over an indefinite extended period of years of illness. While it is true that a bona fide plan for sick pay might have provided for a longer period on behalf of the president than would have been adopted for other

130. *Id.*
131. 50 T.C. 422 (1968).
132. *Id.* at 427.

> employees, we do not believe that such period would have covered so extended a span of years as is before us now if he were not the principal stockholder and in fact the true owner of the business.[133]

The basic premise underlying the court's conclusion was that it would not have been a rational business decision for a financially struggling corporation to make unlimited payments to all sick employees; therefore, the intent of the framers was not to compensate employees for their productivity, but rather to compensate the president, because he controlled the corporation.[134]

The *Levine* holding presents a serious problem for small corporations with financial difficulties. This problem may be overcome either by showing a prior history of making extended payments, or more easily, by limiting the payment of benefits to a percentage of the employee's salary or perhaps by paying benefits out of a fund contributed to by the employer only to a certain percentage of gross income.[135]

E. Retention of the Discretionary Right to Make Payments with the Intent to Favor Shareholders over the Non-shareholder Members of the Plan

A corporation's retention of the power to favor certain employees over others opens the possibility of favoring shareholder-employees over employees not holding an equity interest. However, the mere retention of such a power is not sufficient to defeat the plan inasmuch as such a power is equally consistent with an intent to adapt the plan to employees as their value to the company increases without having to resort to a board meeting to vote on his inclusion. Nevertheless, when this retention of power is coupled with an intent to favor shareholders over non-shareholder employees, it is reasonable to conclude that the "for employees" requirement has not been met.

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133. *Id.*

134. It should be noted that the *Levine* plan limited sick pay continuation to $100 per week; however, the number of weeks was not limited. The court did not eliminate the plan, but simply restructured it to be operative for a reasonable period of time. No employee except the president received sick pay for more than a few weeks. The president's illness had been continuing for five years as of the date of the opinion and was likely to continue. *Id.* at 425.

135. Skolnick proposes either a fixed dollar limit or a percentage of the employee's compensation. Skolnick, *Employee-Stockholders Can Benefit from Medical Reimbursement Plans*, 50 TAXES 595, 598 (1972).

This intent fact is illustrated by the *Larkin* case.[136] In *Larkin*, the plan was designed to cover employees "that the officers at their discretion consider should be covered."[137] The corporation's unwillingness to commit itself to a firm course of action in regard to employees was an indication that the corporation might have wanted to favor shareholders over non-shareholder employees.[138] However, this fact may have equally indicated the officers' intention to retain the discretion to benefit only those employees who proved productive to the corporation. The court concluded against the existence of a plan because there was oral testimony from an officer to show that it was the intent of the drafters to favor shareholder participants over non-shareholder participants:

> Here the amounts to be paid and the circumstances under which they were to be paid were decided on an ad hoc basis. Alan Larkin, the only witness, acknowledged that the employees were not informed directly even of the existence of the plan; further, that even if an employee were covered, he would not necessarily be paid for unusually heavy medical bills. No limits were determined as to time or amount.[139]

F. Coverage of Non-employees

Another recent case on what constitutes "for employees" is *Charlie Sturgill Motor Co.*,[140] wherein the corporation's plan included two sons of Mr. and Mrs. Sturgill. The sons did not provide any employment-type services to the corporation, albeit they were nominally the vice-president and treasurer of the corporation, respectively.[141] The plan adopted identified these sons by name and not as dependents or relatives of the employee participants.[142] This fact evinced a lack of intent to pay benefits under the plan to the recipients as a consequence of their relationship to the corporation as employees or relatives thereof.[143] Failing to meet the requisite intent, the *Sturgill* plan was held not to be "for employees."

136. 48 T.C. 629 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968).

137. *Id.* at 631.

138. This flexibility was distinguished in subsequent cases as being the reason for holding otherwise where such flexibility was not present. *See* Bogene, Inc., 27 CCH Tax Ct. Mem. 730 (1968). This appeared to give indirect support to the proposition that the existence of flexibly administered plans would be fatal. As the text indicates, such a conclusion is erroneous.

139. Alan B. Larkin, 394 F.2d 494, 495 (1st Cir. 1968), *aff'g* 48 T.C. 629 (1967).

140. 32 CCH Tax Ct. Mem. 1336 (1973).

141. *Id.* at 1346-49.

142. *Id.* at 1348-49.

143. *Id.* at 1349.

Sturgill does not stand for the proposition that a plan may not cover the spouse and dependents of the employee, at least under a medical expense reimbursement plan as provided in section 105(b).[144] To the contrary, the section specifically states that such a plan may reimburse the employee's medical expenses incurred for himself, his spouse, and his dependents. However, the normal plan would at most simply designate the employee's proper name and include the spouse and dependents by a general reference. The specific designation of the Sturgill sons was merely an indication of the drafters' intent to favor the recipients for reasons other than their employment relation to the corporation.[145]

G. Independent Advice

Most cases deciding the "for employee" requirement have noted that the plan germinated upon the suggestion of an accountant or an attorney.[146] It would appear that such fact is probative of the intent on the issue of whether the plan was designed to benefit the recipients in their capacity as employees or in their capacity as shareholders. The underlying, and often undiscussed, premise is that if one is advised to act in a specified manner to accomplish certain objectives, and he subsequently does act, it is likely he acted for the prescribed motivation.

This factor was given heightened attention in *Edward D. Smithback.*[147] Upon incorporation of Ed Smithback Plumbing, Inc., a health plan was adopted pursuant to the suggestion of Edward Smithback's accountant and attorney that

144. See note 1 *supra.*

145. A common finding favorable to the existence of a shareholder-employee plan is that each member be productive. *See, e.g.,* Nathan Epstein, 31 CCH Tax Ct. Mem. 217 (1972); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970) (both Mr. and Mrs. Smith devoted their full time to the business). Hence, the quantum of productivity may be important to determine if the recipient is in fact an employee.

146. Charlie Sturgill Motor Co., 32 CCH Tax Ct. Mem. 1336, 1347 (1973); Nathan Epstein, 31 CCH Tax Ct. Mem. 217, 219 (1972) (the accountant suggested the plan as an alternative to increased compensation); E.B. Smith, 29 CCH Tax Ct. Mem. 1065, 1066 (1970) (accountant's advice was not determinative of existence of a plan "for employees," since such advice was merely an expression of the availability of the section without strong evidence of the personal savings); Edward D. Smithback, 28 CCH Tax Ct. Mem. 709, 710 (1969) (advice of attorney and accountant); Samuel Levine, 50 T.C. 422, 424 (1968) (president was told of section 105 benefits by an Internal Revenue Agent who was sharing a hospital room with the taxpayer, who at the time was recovering from a stroke); Bogene, Inc., 27 CCH Tax Ct. Mem. 730, 731 (1968) (advice of accountants).

147. 28 CCH Tax Ct. Mem. 709 (1969).

> [a]s a benefit of incorporating, Edward could reduce his income taxes by having the company pay and deduct from its income taxes Edward's and his family's personal medical expenses, and that such payments would be excludable from Edward's individual income. Edward was advised that any plan for such payments could discriminate in effect among employees by providing for payment only of the medical expenses of the company's full-time salaried employees, of which Edward would be the only one, and that the plan did not have to be in writing.[148]

As a consequence of this advice, the court concluded that the purpose of the plan was for Mr. Smithback to avoid the personal income taxes on the benefits received.[149] The court concluded that the plan was designed to benefit Mr. Smithback in his capacity as the owner of the business rather than as an employee:

> [W]e are persuaded the purport of the plan was to benefit Edward as owner of his plumbing business and as the sole stockholder of the corporate business. We understand the genesis and the primary purpose of the plan—indeed, of the incorporation of Edward's business—to have been the avoidance of Federal taxation, a purpose which obviously was to benefit Edward in his capacity as owner of the business rather than as employee. The plan did not confer any health or medical benefits upon Edward *as employee*.[150]

Thus, proof of the requisite intent may be evidenced by the state of mind of the framer of the plan in seeking and receiving advice from an accountant or an attorney.

It should be noted, however, that the *Smithback* case does not stand for the proposition that the adopters of the plan may not be motivated by a desire to realize the favorable tax consequences. In *Arthur R. Seidel*,[151] a corporation performing services as representatives of electrical manufacturers through its two sole employees (who were also 50% shareholders), adopted a health plan one year after receiving a brochure published by a certified public accountant entitled *How to Get "Free" Medical Care—Or At Least Reasonable!*[152] As the title indicates, the brochure described how shareholders of closely-held corporations may receive the tax benefits of section 105. In holding that the plan was nonetheless "for employees,"[153] the court

148. *Id.* at 710.
149. *Id.* at 711.
150. *Id.*
151. 30 CCH Tax Ct. Mem. 1021 (1971).
152. *Id.* at 1022-23.
153. *Id.* at 1026.

noted that the existence of an intent on the part of the framers to receive the tax benefits provided in section 105 was insufficient in itself to negate a coexisting intent that the recipients under the plan be benefited solely as a function of their employment relationship to the corporation:

> It may be that when [the two fifty-percent shareholders], as the directors of the corporation, adopted the several employee benefit plans in 1966, they were in part motivated by a realization of the tax benefits that could be derived from the establishment of such plans; yet, the existence of such a motivation does not justify our holding the plan invalid. If a plan within the meaning of section 105 was adopted, then they are entitled to the tax treatment provided by law for the benefits paid under such a plan.[154]

The *Seidel* and *Smithback* decisions may be reconciled and distinguished by the degree to which the tax incentive was a significant motivational force. In *Smithback,* it appears that the plan was specifically limited to the company's full-time salaried employees because Mr. Smithback himself would be the only such employee. The plan was also adopted at the same time he incorporated his sole proprietorship for the express purpose of limiting liability and saving income taxes.[155] Despite the fact that he was the only full-time salaried employee and of such utility to the corporation to qualify as a natural category to justify the exclusion of the other three employees from the benefits under the plan, there was simply no evidence to indicate that the plan was adopted with the intent that he receive the benefits as an employee. The saving on his own personal income taxes appears to have been his sole objective, indicating that the plan was not adopted with the intent of benefiting himself in the capacity of an employee.

In *Seidel,* however, the mere recognition that the two 50% shareholders, as sole employees, were likely to receive benefits under the plan in disproportion to their shareholder interests[156] was sufficient evidence of an intent that the plan benefit the participants as employees, and not as shareholders. The existence of this intent fact alone was sufficient to dissipate any contention that the personal tax benefits indicated an intent to benefit them as shareholders. It is likely that the use of the "tax saving" purpose as an intent fact will be limited. It would indeed be an incredible contention that, as its underlying

154. *Id.*
155. 28 CCH Tax Ct. Mem. at 710.
156. See text accompanying notes 151-54 *supra.*

premise suggests, the mere recognition of the tax benefit would prevent its very operation.

III. Deductibility of Employer Benefit Payments

It has long been believed that a plan had to meet the tests of section 105 of "plan for employees" before payments thereunder would be deductible by the business entity.[157] This has perhaps been caused by the Treasury regulation which provides that payments under certain benefit plans may be deducted as a business expense if "ordinary and necessary."[158] However, recent cases have established that if reasonable, the corporate payment may be deductible as compensation even if the plan fails.[159] The Commissioner has quickly conceded the rationale of the point.[160]

Hence, if the plan fails to qualify because of the "for employee" limitation, the alternate test for deductibility becomes the "reasonableness" of the payments.[161] In the determination of "reasonable compensation," both *American Foundry* and *Sturgill* place primary emphasis on the relationship between the total value of compensation received—salary plus the value of any other fringe benefits including the health plan—and the services performed by the employee for the corporation.[162] As the court noted in *American Foundry*, the health plan was the only fringe benefit given to Domenic,

157. Alan B. Larkin, 48 T.C. 629, 635 (1967), *aff'd*, 394 F.2d 494 (1st Cir. 1968) (on failure of the plan, the amounts paid pursuant thereto were not deductible by the corporation); E.B. Smith, 29 CCH Tax Ct. Mem. 1065 (1970); *cf.* Nathan Epstein, 31 CCH Tax Ct. Mem. 217, 220 n.4 (1972). In a factual situation that tested the converse proposition because the plan was held to qualify under section 105, the court stated: "A necessary corollary of section 105 is that if the payments are excludable from the gross income of the employee because they are made under a 'plan for employees,' the corporation is entitled to a deduction for such payments under section 162(a)." Bogene, Inc., 27 CCH Tax Ct. Mem. 730, 734 (1968) (footnote omitted). This relatively early case suggested an equality between a section 105 plan and corporate deductibility such that a nonqualifying plan for the employee meant non-deductibility for the corporation.

158. See Treas. Reg. § 1.162-10(a) (1958).

159. Charlie Sturgill Motor Co., 32 CCH Tax Ct. Mem. 1336, 1349 (1973); American Foundry, 59 T.C. 231, 243-45 (1972).

160. 1974 Int. Rev. Bull. No. 14, at 7.

161. Note that the same result might not be reached if the "plan" fails for lack of articulation, commitment, or notice. The apparent condition precedent, other than "reasonableness," to the corporate deductibility as compensation is a contractual relation between the corporation and the employee. American Foundry, 59 T.C. 231, 243 (1972). However, as *American Foundry* indicates, the contractual relation for the fringe benefits will probably exist where the employee has mere knowledge of the benefit plan. *Id.* at 243-44.

162. See note 159 *supra*.

and a salary "of $23,082.00 coupled with an agreement of employer-paid medical expenses was not excessive compensation to Domenic Meaglia."[163]

In determining the value of a health and accident plan, the *American Foundry* court affirmed regulation section 1.162-7(b) which states that the circumstances to be considered in determining reasonableness "are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."[164] Thus, the *American Foundry* court noted that Domenic at the time of the adoption of the plan was in good health, with nothing in his past medical history to indicate that he would suffer such a long and serious illness.[165]

Beyond what has already been stated, whether or not a health plan constitutes reasonable or excessive compensation becomes a question of advocacy based upon a sophisticated analysis of facts. It is sufficient to note that, for the purposes of this Comment, an alternative avenue for employer deductibility exists if the plan does not qualify under section 105.

IV. CONCLUSION

The validity of section 105 plans frequently hinges upon the presence of four main elements: an articulation of the conditions upon which payment will be made, a demonstrated commitment to the articulation, a reasonable attempt to impart notice of the plan, and a requisite intent that the benefits be paid as a consequence of employment services. A writing is the safest method of creating a plan because it can reflect the presence of these elements; however, as has been indicated, section 105 plans may also be formed orally or through custom. Nevertheless, a consuetudinal plan is subject to the inherent weakness of requiring a prior history of payments, the absence of which would leave the scope undefined and may threaten the very existence of the plan.

The paucity of case law or legislative illumination in two areas is likely to engender litigation in the future. First, inasmuch as the purpose behind the notice requirement has not been precisely defined, advocates on both sides of the tax bar can be expected to seek an input while the subject is still malleable. Second, where a plan fails because it is not deemed to be for employees, what happens to the legitimately

163. 59 T.C. at 240-41.
164. *Id.* at 244.
165. *Id.* at 238-39.

compensated employees? A court addressing this issue could conclude that a plan which compensated both employees and ineligible shareholders had a two-fold and severable motive: to compensate employees for their employment relationship and to compensate shareholders for their equity relationship. Under such a hybrid plan, to the extent that payments were received under the employees' portion, excludability would be allowed. Conversely, to the extent they were received under the improper portion, excludability would be denied.

Section 105 plans provide an attractive vehicle for employers to confer tax-free benefits on their employees. But the draftsman should not be misled by the deceptive simplicity of section 105 requirements. While apparently uncomplicated, these plans require careful forethought, especially where the employer misconstrues section 105 as a device whose principal attractiveness is the ability to benefit shareholder-employees.

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