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## THE NEW TAX POLICY ON DEFERRED COMPENSATION

*Ralph S. Rice\**

**N**o single factor of income tax planning today exceeds in importance those devices under which payment of tax with respect to services performed by an employee in his peak earning years is postponed until the compensation is actually paid to him at a later date. It is normally expected that through these devices payment will be made to the employee after he has partially or fully retired and no longer encounters the high tax burden which arises from progressive rates at the time the services are rendered.

The several ways in which income of an employee may be deferred through cooperation with employers may be recounted briefly. Extensive statutes deal with the very desirable device of deferring employee compensation (and permitting its receipt at capital gain rates) through pension, profit-sharing and stock bonus plans.<sup>1</sup> Employee compensation may be deferred and in addition made available at capital gains rates through use of stock option plans.<sup>2</sup> Deferred compensation (payable, however, to employee's dependents rather than the employee himself) also may be available under so-called widows' benefit<sup>3</sup> plans and split dollar insurance.<sup>4</sup>

The simplest method of spreading employment income, however, arises where an employer simply makes an agreement with an employee to postpone payment of salary to him until a subsequent date. This device is most desirable where the employee is on a cash basis; an employee on the accrual basis would have income under Treasury regulations, sections 1.446-1 (c) (ii) and 1.451-1 (a) when the fact of the employer's liability became fixed, and the amount was set. Since a great majority of taxpayers use the cash basis in making tax returns with respect to their income as employees, this limitation does not seriously restrict use of the device.

Deferred compensation arrangements of this nature have some disadvantages over other devices. However, they also have substantial advantages not afforded through other means. As distinguished from so-called "qualified" pension, profit-sharing, and stock bonus plans, informal deferred compensation arrangements can

<sup>1</sup> INT. REV. CODE OF 1954, §§ 401-404, 501.

<sup>2</sup> *Id.*, § 421.

<sup>3</sup> *Id.*, § 101 (b) (1).

<sup>4</sup> Rev. Rul. 55-713, 1955-2 CUM. BULL. 23.

be made with employees selected at the will of the employer. Under an informal deferred compensation plan, discrimination of any kind or character between employees thus is allowable provided only that total compensation paid each employee is reasonable within the intentment of Internal Revenue Code, section 162. While there is thus very little limitation on the amount payable to a single employee through informal deferred compensation (including employees who in Hollywood idiom are in the "son-in-law business"), such a limitation does exist as to formal pension and profit-sharing plans. Many employers have a pension plan applicable to all employees within a group, but desire to offer additional informal deferred compensation arrangements to a limited number of executives whose need for (or ability to command) deferment exceeds that of the general group. In addition, deferred compensation arrangements of course are effective as to the employee himself rather than his dependents; hence they are obviously more desirable in many cases than benefits for dependents. Finally, the employer gets a deduction for compensation paid under proper deferred compensation arrangements; in this and other respects informal deferred compensation is more desirable than stock option plans.

Thus, the freedom of informal deferred compensation plans has been most attractive to tax counselors. However, the courts and the Commissioner have in years past been so vague about the scope of the device that many have, *in terrorem*, been extremely cautious in using it. In February 1960, however, the Commissioner clarified his position very considerably by the issuance of Revenue Ruling 60-31.<sup>5</sup> Because of the importance of this device in tax planning and the scope of the ruling, it is desirable now to review:

1. The circumstances in which and the extent to which tax savings through informal deferred compensation arrangements are currently allowable, and
2. The practical effect of the ruling and its place in current legislative and administrative structures for the taxation of income.

It has always been necessary to approach informal deferred payment plans with caution; otherwise bunching of income may result. For example, where a taxpayer leaving a corporate employer is given funds from a non-qualified profit-sharing trust, all

<sup>5</sup> 1960-5 INT. REV. BULL. p. 17.

the sums he receives are considered ordinary income to him in the year of receipt.<sup>6</sup> The same is true of other separation payments,<sup>7</sup> particularly where cancellation of an employment contract is involved.<sup>8</sup> This should be avoided since bunched income invites progressive rates of tax.

*Doctrines Which Restrict Deferred Compensation Arrangements:  
"Economic Benefit" and "Constructive Receipt"*

Courts commenting on deferred compensation arrangements have sometimes expressed their views in terms of a so-called "economic benefit" doctrine. This is a grandiose way of saying that income will be attributed to a taxpayer who is on the cash basis even though he receives something besides cash.<sup>9</sup> That is, if a taxpayer is paid in potatoes or typewriters, income will be attributed to him to the extent of the fair market value of these items when he receives them. Cases in this area become quite difficult

<sup>6</sup> *Frazier v. Commissioner*, 157 F.2d 282 (6th Cir. 1946).

<sup>7</sup> A substantial numerical preponderance of the cases attribute income to an employee who receives a lump sum when he leaves the employment of another. This is for the reason that the courts feel that the payments are really motivated by past services and on this basis must be treated as compensation. See for example, *Carragan v. Commissioner*, 197 F.2d 246 (2d Cir. 1952); *Chauncey L. Landon*, 16 B.T.A. 907 (1929); *Beatty's Estate*, 7 B.T.A. 726 (1927). The item is more likely to be treated as income if it is found that the amount of payment is measured by the salary of the recipient. *Willkie v. Commissioner*, 127 F.2d 953 (6th Cir. 1942); *Chauncey L. Landon*, *supra*. Perhaps the courts are simply looking for unguarded language in contemporaneous records such as corporation minutes and correspondence, but it must be noted that great emphasis is placed upon the language in which the transaction is couched. Such phrases as "in recognition" and "in appreciation" or references to "obligation," "remuneration" and "salary" have been used in attributing income. See *Willkie v. Commissioner*, *supra*; *Botchford v. Commissioner*, 81 F.2d 914 (9th Cir. 1936); *Walker*, 25 T.C. 832 (1956); *James H. Anderson*, 31 B.T.A. 197 (1934), *aff'd per curiam*, 79 F.2d 979 (2d Cir. 1935); *Arthur L. Lougee*, 26 B.T.A. 23 (1932). Compare, however, *Cunningham v. Commissioner*, 67 F.2d 205 (3d Cir. 1933). Reference is also made to the fact that the employer making the payment deducted it as an expense; this is especially fatal if the employer charged it to a salary account. See *Botchford v. Commissioner*, *supra*; *Fisher v. Commissioner*, 59 F.2d 192 (2d Cir. 1932); *James H. Anderson*, *supra*; *Arthur L. Lougee*, *supra*; *Robert E. Binger*, 22 B.T.A. 111 (1931); *Willis L. Garey*, 16 B.T.A. 274 (1929). Compare *N. H. Van Sicklen, Jr.*, 33 B.T.A. 544 (1935). In an early case, a listing of a payment of a gift was thought to preclude its attribution as salary to an employee. *Estate of Daly*, 3 B.T.A. 1042 (1926). However, this is certainly not the law in the Second Circuit (or probably elsewhere) today. *Carragan v. Commissioner*, *supra*. Similarly, emphasis has been placed in these cases (as well as in others discussed in previous paragraphs) upon the fact that the governing body of the enterprise making the payment had no authority to make a gift. *James H. Anderson*, *supra*; *Beatty's Estate*, *supra*.

<sup>8</sup> *F. W. Jessop*, 16 T.C. 491 (1951); *Charles J. Williams*, 5 T.C. 639 (1945); *George K. Gann*, 41 B.T.A. 388 (1940); *Thurlow E. McFall*, 34 B.T.A. 108 (1936).

<sup>9</sup> *Treas. Reg.* § 1.446-1 (a) (3) (1957); *W. P. Henritze*, 41 B.T.A. 505 (1940) (*semble*).

to distinguish. For example, notes<sup>10</sup> and checks<sup>11</sup> have been held to constitute income. On the other hand, it appears clear that "A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intentment of the cash receipts and disbursements method."<sup>12</sup>

Consequently, it is clear that some kinds of "economic benefits" are included in measuring the taxpayer's income, while other kinds are not. There is no way of telling in advance what will or will not be treated as income except on the basis of the decided cases; the enterprise for the taxpayer is the familiar one of drawing a line between an unsecured promise to pay money (which creates no income to a cash basis taxpayer) and a promise which is made in the form of a note or other evidence of the indebtedness (which

<sup>10</sup> Where a note is given by a corporation to an employee and the evidence shows that it is intended as compensation rather than mere evidence of indebtedness, the note may represent taxable income. *Schlemmer v. United States*, 94 F.2d 77 (2d Cir. 1938). See also *Cherokee Motor Coach Co. v. Commissioner*, 135 F.2d 840 (6th Cir. 1943).

But even in the absence of an intention to compensate, it is the position of the Commissioner that "notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer." *Treas. Reg. § 1.61-2(d)(4)* (1957). See also *Anthony P. Miller, Inc. v. Commissioner*, 164 F.2d 268 (3d Cir. 1947).

It should be noted that while receipt of a note may create taxable income, merely giving of a note does not represent payment so as to authorize a deduction by a taxpayer on the cash basis: he has, of course, actually paid nothing in cash. *Helvering v. Price*, 309 U.S. 409 (1940).

<sup>11</sup> A leading case is *Lavery v. Commissioner*, 158 F.2d 859 (7th Cir. 1946), in which a taxpayer received a check on December 30 and cashed it on the succeeding January 2. It was held to be income to him on December 30 on the basis of a predecessor to *Treas. Reg. § 1.451-2(a)* (1957). The terms of the earlier regulation did not differ substantially from the present one. The court held that the receipt of the check was equivalent to the receipt of cash since the taxpayer could have cashed it on the day it was received by him, or at least on December 31. There was no doubt about the validity of the check or the solvency of the drawer. The Tax Court has gone farther and held that even where a check was received after banking hours on December 31 it was income in the year received. *Charles F. Kahler*, 18 T.C. 31 (1952). Moreover, it has been held that a dividend check represents income when it is issued if it is mailed on December 31, where the stockholder can pick it up at the office and instead requests that it be mailed to him. *Frank W. Kunze*, 19 T.C. 29 (1952), *aff'd per curiam*, 203 F.2d 957 (2d Cir. 1953). On the other hand, if the practice is to put the checks in the mail on December 31 and the recipient could not get it in any event until the next year it has been held that the payment is not income to him until the next year. *Avery v. Commissioner*, 292 U.S. 210 (1934). See also, *W. A. Sloper*, 1 T.C. 746 (1943). Compare, however, *McEuen v. Commissioner*, 196 F.2d 127 (5th Cir. 1952).

<sup>12</sup> *Rev. Rul. 60-31, 1960-5 INT. REV. BULL.*, p. 17 citing *United States v. Christine Oil & Gas Co.*, 269 Fed. 458 (W.D.La. 1920); *Jackson v. Smietanka*, 272 Fed. 970 (7th Cir. 1921) and *E. F. Cremin*, 5 B.T.A. 1164 (1927).

The case of *C. Florian Zittel*, 12 B.T.A. 675 (1928) is also cited in the ruling, the following language being quoted from the opinion: "Taxpayers on a cash receipts and disbursements basis are required to report only income actually received no matter how binding any contract they may have to receive more." However, it is doubtful that a rule so broadly stated currently represents the law; certainly the Service would not agree to it. See *Treas. Reg. § 1.451-2* (1957).

may be said to convey an economic benefit which is the equivalent of cash and hence to be taxable as income when made to a cash basis taxpayer).

A second concept much discussed in deferred compensation cases concerns constructive receipt. In general the rule may be stated to be that where a taxpayer can reach out and take income for himself, and fails to do so, he will be treated for income tax purposes as though he had in fact taken it. The ramifications of this doctrine are too general to be discussed here. However, it is necessary to examine the doctrine to the extent that it applies to arrangements under which compensation is deferred pursuant to contractual arrangements between employer and employee. It may be noted initially that the regulations require income to be attributed to a taxpayer in the year in which it is either actually or constructively received.<sup>13</sup>

The basic theory respecting the constructive receipt doctrine in deferred income cases is illustrated by the new Revenue Ruling which furnishes the occasion for these comments.<sup>14</sup> As a preliminary, we should consider the recital in the regulations that:

“Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time.”<sup>15</sup>

This is interpreted in the Revenue Ruling in the following terms:

“Thus, under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. . . . Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another. . . .”

This general admonition is not, however, given substantial effect in the specific examples considered. Indeed the ruling significantly expands the usefulness of informal deferred compensation devices in cases where it had previously been thought necessary to impose some condition which the employee would be required to fulfill before deferred compensation could be paid to him.

<sup>13</sup> Treas. Reg. §§ 1.451-1 (a) and 1.446-1 (c) (1) (i) (1957).

<sup>14</sup> Rev. Rul. 60-31, 1960-5 INT. REV. BUL., p. 17.

<sup>15</sup> Treas. Reg. § 1.451-2 (a) (1957).

The regulations have for many years provided in part that "Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."<sup>16</sup> Pursuant to this rule, a number of devices providing for conditions (often purely formal) on receipt of deferred compensation became common.<sup>17</sup> To put the problem in the context of a cash basis taxpayer, the theory here was that he would in fact receive no cash when his services were rendered and that the doctrine of constructive receipt could scarcely be extended to apply to situations in which his right to receive payments of a measurable value at a specific time was conditional rather than absolute. Such deferred compensation arrangements reflected a variety of contingency clauses. A favorite among them was the requirement that the employee should, after formal retirement, render services as a consultant in return for which payments in the sum stated would be made. A similar requirement was that the employee after his term of employment should not enter into a competing employment with another or compete as a sole trader or partner. Other conditions included making the compensation contingent upon his total income upon retirement, or the length of time the employee was employed by the employer, or the financial ability of the employer to pay after retirement. (The last qualifications particularly are directed toward reducing the rights of the employee for commercial as well as tax reasons. It is clear that many of them will be retained for commercial purposes in the future, even where not required for tax savings.)

#### *The Effect of the Ruling on Concept of Constructive Receipt*

The effect of such limitations has been sharply limited under Example 1 of Revenue Ruling 60-31. In that example the Commissioner considered circumstances in which an employee under contract received a stipulated annual salary and additional compensation credited to a bookkeeping reserve account. The latter amount was to be deferred, accumulated, and paid in annual installments upon retirement of the employee. The agreement recited that the money was not intended to be held in trust by the employer for the employee. The payments were not conditioned upon the performance of consultative or other services, agreements

<sup>16</sup> *Ibid.*

<sup>17</sup> These appeared to be supported by such cases as *Commissioner v. Oates*, 207 F.2d 711 (7th Cir. 1953); *Fred C. Hall*, 15 T.C. 195 (1950), *aff'd per curiam*, 194 F.2d 538 (9th Cir. 1952); *Harry B. Sidles*, 19 T.C. 1114 (1953); *Howard Veit*, 8 T.C. 809 (1947).

not to compete, or the like. It was held that the deferred income was taxable to the employee only when actually received; the device was successful. Hence the existence of conditions on payment of the deferred compensation appears no longer imperative to insure that they will not be taxed to an employee on the cash basis before actual receipt.

There has been a semantic variation of the concept of conditional deferments. One comment frequently made with respect to deferred compensation agreements in the past has been that the rights of an employee to deferred compensation could not be vested but must be forfeitable; otherwise the employee must be deemed to have received income in the year in which he performed the services out of which deferred compensation was subsequently to arise. It is thought appropriate to mention this factor, although reflection will reveal that references to whether the interest of the employee is forfeitable really constitute only a restatement of the rule that control of the receipt of deferred income must be "subject to substantial limitations or restrictions," as suggested at section 1.451-2 (a) of the Treasury regulations, or constructive receipt will be attributed to the employee at the time he originally renders services. It must be assumed that this earlier requirement is no longer law but is rejected also by the specific conclusion in the Revenue Ruling that the arrangements discussed in Example 1 were effective even where no conditions were imposed with respect to payment of the deferred compensation.

The language of other opinions in the past has suggested that one factor in attributing deferred income to an employee during the year in which he performed services was that the employee might in fact have been able to induce the employer to make payment during that year rather than at a later date. It might be argued that this basic philosophy is a part of the constructive receipt concept; that is, that the employee could have gotten the property at an earlier time if he so desired. The ruling lays this requirement to rest.<sup>18</sup>

<sup>18</sup> It is made abundantly clear in the ruling that the possibility that the payor would have been willing to agree to an earlier payment is irrelevant; the case of *J. D. Amend*, 13 T.C. 178 (1949) is cited. However, *C. E. Gullett*, 31 B.T.A. 1067, 1069 (1935) is quoted to the following effect: "It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice." The effect of the last clause is not clear; presumably it is not intended to qualify the general rule stated elsewhere in the ruling.



It is now likewise clear that in some cases future payments for past earnings may be deferred. As all students of the subject know, the leading case in this area is *Commissioner v. Oates*,<sup>19</sup> in which an insurance agent had retired from active service with an insurance company. He was entitled to renewal commissions, of which he was to receive a disproportionately large sum during his first year. He and other agents agreed with the company that these payments should be deferred to subsequent years. The payments arose from policies sold (that is, in effect, services rendered) prior to the time that the agreement with the company was renegotiated to provide for deferred income. It was held that the arrangements for deferred income should be given effect for tax purposes and that the agent should not be held to have had constructive receipt of premiums pursuant to the terms of the agreement which he originally entered into with the company but rather should be treated as receiving income on a deferred basis pursuant to the subsequent arrangement.

On the basis of the *Oates* decision, tax counsel in some cases subsequently permitted clients, after services had been rendered, to change previous arrangements which would have lumped retirement or other income into a single year. The objective of the change was to insure that payment would be spread, on a deferred basis. However, since the Internal Revenue Service had non-acquiesced in the decision, some counsel thought that this procedure carried with it substantial dangers. This non-acquiescence was withdrawn correlative with the issuance of the ruling.

What does the withdrawal of the non-acquiescence signify? It does not, of course, mean that a taxpayer will in all cases be given carte blanche to make deferred compensation arrangements after income has actually been earned but before it has been received by a cash basis taxpayer. The only thing that can be presumed to be established is that where deferment of receipts for past services follows the pattern of the *Oates* case, the deferred compensation arrangement will not be attacked by the Commissioner.<sup>20</sup> For example, consider circumstances in which the spreading arrangements (in a case otherwise like *Oates*) were not entered into until

<sup>19</sup> 207 F.2d 711 (7th Cir. 1953).

<sup>20</sup> The Commissioner here appears to have gone farther toward taxpayer indulgence than some cases would have required. The fact that parties have changed an earlier arrangement for compensation to suit their tax convenience has been the occasion for critical judicial comment in cases where tax avoidance devices have been stricken down. *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955); *George W. Drysdale*, 32 T.C. 378 (1959).

after a right to the renewal commissions had crystallized so that the taxpayer could take down the payments at any time in his sole discretion. Certainly there is no assurance that such an arrangement would not be successfully attacked by the Commissioner and income attributed to the taxpayer in accordance with the original agreement. Indeed there is great likelihood that the agreement would be so contested.

*Effect of Ruling on Deferment Devices for Entrepreneurs and Professional Persons*

Cases and rulings authorizing deferment of compensation have not thus far been extended to business profits of independent entrepreneurs such as brokers, professional men and others engaged in business enterprises. Apparently taxpayers have feared attempting to extend informal deferred compensation this far. The wisdom of this restraint is emphasized by the ruling. In the fifth example there discussed a boxer, his opponent, and a boxing club agreed to stage an exhibition. An arrangement was made that one boxer (taxpayer) was to receive approximately sixteen percent of the gross receipts. However, his share of the gross receipts was to be held by the boxing club and spread through payments to the taxpayer over a period of four years. The ruling recited that all of the income to be paid to the boxer was attributable to him in the year it was earned because the boxer was not an employee of the boxing club. On the contrary, his share of the gross receipts from the match belonged to him and never belonged to the club.

Certainly the same rule would be applicable in any case involving a joint venturer in a business enterprise where the funds are held by one joint venturer in an attempt to defer income to the other. However, as noted in the succeeding paragraph, an exception is made in the regulation for cases involving authors; this raises a question respecting whether the same rule would apply where a payor (*e.g.*, a client) deferred payment to several joint venturers (*e.g.*, an associated group of independent attorneys). This question is not resolved.

*Special Benefits from Deferred Compensation Agreements Permitted to Authors*

Tax advantages are also made available under certain circumstances in which an author sells publication rights for his book. In Example 3 discussed in the ruling, specific royalties based on cash

received from sales of copies of the work were agreed upon between author and publisher. In a separate agreement the parties agreed that notwithstanding the first contract, the publisher would not pay more than a stated amount per year to the author. Sums earned in excess of that amount during the year would be carried over by the publisher into a succeeding accounting period and thereafter paid; he was not required to pay interest on such sums or to segregate them in any manner.

The Commissioner ruled that the author was not required to report income in the year in which the royalty payments were earned, but only in the year in which they were to be received. Emphasis was placed upon the following factors: (1) The two agreements should be read as one, and (2) the agreement was made before the royalties were earned.

It was ruled that this arrangement could not be distinguished from the one (Example 1 of the ruling) in which tax deferment was authorized where an employer agreed to make additional salary payments to an employee at a period of time commencing five years after services were rendered by the latter.

#### *Deferment Devices May Not Be Supported by Security Arrangements*

Prior to the adoption of Revenue Ruling 60-31, courts had concluded that amounts paid into a trust which was not a "qualified" pension trust but was created in order to provide for deferred payments to a recipient employee were taxable to him when the amounts were paid over since they were "irrevocably paid out" for his "sole benefit." This is because the use of this device to insure that payment is ultimately made to the employee actually represents a constructive receipt by him.<sup>21</sup> This view is also incorporated in the statute.<sup>22</sup>

<sup>21</sup> E. T. Sproull, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); David W. Anderson, 5 T.C. 1317 (1945); K. R. Kingsbury, 31 B.T.A. 1126 (1935).

This problem was considered also in George W. Drysdale, 32 T.C. 378 (1959) where an employer paid funds to a trustee for the benefit of certain employees who had non-forfeitable rights in the trust. The taxpayer contended that in order to receive the payments he was required to render consulting services, but the trust did not provide that on a forfeiture by the employee the funds would return to the employer. In a somewhat unsatisfactory decision it was held that the payments should nevertheless be attributed to the employee when paid to the trustee by the employer rather than the later date when sums were paid by the trustee to the employee. The basis for the holding is not altogether clear, although it is said that ". . . the employment contract was fully executed as far as the years in issue are concerned . . ." and that "the Detroit Trust Company was simply petitioner's designated agent."

No statute requires this result where payment is made in escrow, but it has been assumed that the Commissioner would claim that the taxpayer constructively received such payments, and the ruling confirms this view. At Example 4, the question was asked whether a football player realized immediate income from a bonus paid by his employer to an escrow agent, subsequent payments thereafter to be made by the agent to the player over a period of five years, plus interest on the principal amount. In the event of the football player's death, the proceeds were to be payable to his estate. It was ruled that the amounts placed in escrow were income to the football player in the year in which they were placed in escrow, rather than the year in which he actually received them.

This result is consistent with decisions in related areas. For example, where payment has been made to a commercial insurance company for an annuity on behalf of an employee whose rights in the annuity are fixed, payment by the employer represents income to the employee in the year in which payment was made.<sup>23</sup> Of course, the rights of the employee to the annuity would have to be fixed in order to create constructive receipt of income to him.<sup>24</sup>

An employer who pays sums into a non-forfeitable trust or annuity may have a deduction for this amount when it is paid even if no formal pension or profit-sharing arrangement has been made.<sup>25</sup> However, this is really irrelevant from the standpoint of the objectives of informal deferred compensation since the device fails where payments are taxed to the employee when made by the employer.

The holding of the case is likewise unclear, although on the facts presented the result is apparent. Income will be attributed to employees when an employer pays funds into a trust in which the right of the employees are forfeitable, as long as the employer has no right to recapture the funds and the trustee acts as the agent of the employee. A simple statement of that result reflects the imponderables in the decision. For example:

1. Under what circumstances may a trustee of deferred compensation payments be said to be the agent of the employee rather than the employer?

2. Where the rights of an employee to deferred compensation from any fund are conditional, how can it be said that he has received income when another pays sums into the fund, merely because the payor has not parted with dominion?

The test of income to the employee ought to be based on his right to the funds, not whether employer has given up all right to them.

<sup>22</sup> INT. REV. CODE OF 1954, § 402 (b).

<sup>23</sup> It is assumed that the annuity is not "qualified" for the tax advantages of INT. REV. CODE OF 1954, § 401 ff. *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950); *Hackett v. Commissioner*, 159 F.2d 121 (1st Cir. 1946); *Hubbell v. Commissioner*, 150 F.2d 516 (6th Cir. 1945); *Oberwinder v. Commissioner*, 147 F.2d 255 (8th Cir. 1945); *Renton K. Brodie*, 1 T.C. 275 (1942). INT. REV. CODE OF 1954, § 403 (b).

<sup>24</sup> *Ibid.*

<sup>25</sup> See, for example, *Treas. Reg. § 1.404(a)-12* (1956).

It is thoroughly evident that taxpayers planning deferred compensation arrangements other than formal pension, annuity and profit-sharing trusts under Internal Revenue Code, section 401 ff. should studiously avoid current payments into trusts, or in escrow or for annuities on behalf of employees. This aspect of previous law has not been changed by the ruling.

*Deferred Income Arrangements May Protect Employee Against Inflationary Pressures*

It has been noted that in the usual case a deferred compensation arrangement will require that the employer pay a certain sum of dollars to or for the benefit of the employee at a subsequent period of time. This may be undesirable to an employee who fears inflation and desires to get the purchasing equivalent in (for example) 1975 of dollars earned from services rendered in 1961. He may, for example, prefer to have the dollars otherwise owed to him in 1961 put into common stock so that he can get the advantage of what he expects to be a rise in the market by 1975. (Employees can be protected in this respect under pension plans which qualify for advantages of the tax treatment of Internal Revenue Code, section 401 and following statutes. However, for the reasons noted at the beginning of these comments, often an employer cannot or does not want to set up such a trust, perhaps because he does not want to make the plan available to an entire group of employees.)

For the reasons described in preceding paragraphs, the employer cannot put money into a trust for the employee where informal deferred compensation arrangements are desired. If he does so and the rights of the employee are forfeitable, a deduction would be denied to the employer,<sup>26</sup> as it would likewise be denied if he had invested in an annuity.<sup>27</sup> If the money were put in trust, the payment would be attributed to the employee immediately when it was paid out by the employer.<sup>28</sup> Obviously, this is the very worst planning.

In order to avoid these contingencies, it has been suggested that an employer enter into an arrangement with an employee whereby he agrees to pay him at a future date the equivalent to the value of a stated number of shares of a named stock. At the

<sup>26</sup> Under INT. REV. CODE of 1954 § 404 (a) (5).

<sup>27</sup> *Ibid.*

<sup>28</sup> *Id.*, § 403 (c)

time the agreement for deferment is entered into, the employer buys the stocks in his own name and thus will have the stock available to discharge his responsibility for deferred compensation at a future date. The agreement may also provide that he will pay additional shares to the employee, based on the purchase by him annually at a stated date of shares of the stock in question, the number of shares being equivalent to a stated sum of money representing the amount of compensation intended to be deferred annually. One burden on the employer will still exist: he will not be able to take a deduction for the amount invested until payment is actually made to the employee; also, he will certainly have taxable dividend income from the stock during the period prior to payment since he has full ownership. Moreover, when he pays the stock over to the employee he will have capital gain as to any increase in value. These disadvantages may well be offset in large part by the circumstance that when the stock is turned over to the employee the employer will have a deduction for compensation to its full market value.

It was once feared that adverse tax consequences might result if the employer put these stocks in a reserve—not a trust or its equivalent—on his books. This issue was presented in Example 2 of the ruling and resolved in the negative.

Still another refinement for the benefit of the employee is illustrated in the ruling. Under Example 2, after the employer put money into a special account and invested it, the earnings from the account were credited to the account. Thus both the compensation and earnings from it were deferred. [However, the income from the account would be taxed to the employer, as noted above.]

Payment to the employee was made contingent upon his refraining from engaging in a competitive business. He was also required to be available for consultation services and retain his interest in the plan unencumbered. The device was ruled sufficient to defer income to the employee until actual receipt of the payments. Thus, the employer in effect set up a non-qualified pension plan for these employees, without creating income to them at the time the arrangement was set up. Of course the consequences are in many respects less desirable than if the plan were qualified under Internal Revenue Code, section 401 ff.:

1. The employer cannot take a deduction for the amounts payable to the employees until they are actually paid;

2. The employees rely only upon the general credit of the employer to protect their rights to payment;
3. As the income arises in the account, it is taxed to the employer as received since it is his to do with as he desires.<sup>29</sup>

Taxpayers should note two features of the plan reflected in Example 2; absence of either might cause deferment of tax to the employee to be lost.

1. The interest of the employee in the payments was actually conditional. Normally it is not necessary (as seen in Example 1) to make payments conditional; yet the Commissioner might conclude that where the employer was setting up an informal reserve he could do this only where payment to the employee was not vested. It must be conceded that this appears only possible rather than probable, but the ruling is ambiguous on the point.

2. The parties were explicit that merely an informal reserve account but not a trust was involved. Of course if a formal trust were used, the device would probably have the catastrophic consequences noted earlier in these comments: either income would be attributed at once to the employee or the employer would lose his deduction altogether.

There is another danger where a corporate employer puts substantial sums into a reserve to insure that funds are available to discharge obligations of the corporation under deferred compensation arrangements. Internal Revenue Code, section 531 imposes a special tax ranging from 27½ percent to 38½ percent with respect to earnings which are accumulated beyond the reasonable needs of a corporate business. Where a corporation establishes reserves for payments under deferred compensation arrangements to persons who are not shareholders of the corporation, no problems with respect to Internal Revenue Code, section 531 would be expected since such reserves are relevant to the reasonable needs of the business; that is, for payment of indebtedness for past services.

<sup>29</sup> This result is particularly interesting when it is compared with the provisions of Treas. Reg. § 1.402(b)-1(a)(1) (1956) and Rev. Rul. 57-37, 1957-1 CUM. BULL. 18, as modified by Rev. Rul. 57-528, 1957-2 CUM. BULL. 263. These provide in substance that payments to a trust which did not qualify as a pension or profit-sharing trust under INT. REV. CODE OF 1954, § 401 would constitute income to the employee when payment was made to the trust notwithstanding that he could not get the money until a later date. Obviously the examples considered in Rev. Rul. 60-31 were conceived with the primary objective of avoiding regulations of this type. The effort was successful. It was recited at Rev. Rul. 60-31 that "under all of the facts and circumstances of [Examples 1 and 2] no trusts for the benefit of the taxpayers were created and no contributions are to be made thereto. Consequently, Section 402(b) of the Code and § 1.402(b)-1(a)(1) of the regulations are inapplicable."

However, if extensive reserves of this kind are set up for the benefit of an officer and employee who is also a very substantial stockholder in the corporation, the Commissioner may attack the proposed funding on the ground that it is not required by the reasonable needs of the business since there is no arm's-length dealing between stockholders and the corporation. Potential dangers in this area are illustrated in *Pelton Steel Casting Co. v. Commissioner*.<sup>30</sup> Of course each case on this subject turns to an exceptional extent on its own facts and the danger will not be great in all cases. The factor, however, should not be overlooked.

### *Critique of the Ruling*

Every student of our tax structure knows that nothing is easier than to criticize statutes and rulings of the legislative and administrative branch of government; on the other hand, nothing is more difficult than to suggest practicable and logical alternative solutions. The present ruling with respect to informal deferred compensation arrangement is an apt illustration. The conclusion reached, and the manner in which it was made, are characteristic of administrative determinations made by the Service since its inception. However, they may fairly raise a question whether the ruling did not go too far, and whether the system may not be improved.

*Retention of Some Restrictions.* In some respects previous safeguards with respect to deferred compensation arrangements are not disturbed by the ruling. For example, it is still clear that deferred compensation arrangements will not be approved by the Internal Revenue Service in the following situations:

1. Payment is made by an employer on behalf of an employee in escrow to a person who makes deferred payments to the employee thereafter. In substance the treatment here is the same as though the payments had been made in trust; by analogy to statutes applying to trusts for unqualified pension plans, income would be attributed to the employee at the time payment was made to the escrow agent.

2. Where a joint venturer in a business enterprise receives profits which he holds for another joint venturer in an attempt to defer income to the other, the income is attributed to the true owner at the time it is received by the other participant.

<sup>30</sup> 251 F.2d 278 (7th Cir. 1958).



One further observation should be made with respect to restrictive elements of the ruling. It is recited that each case must be determined upon its own facts, and that no advance rulings will be given with respect to informal deferred compensation payments. Thus, it is made clear by the Internal Revenue Service that taxpayers still come into this area at some risk, and that no safe conduct on specific facts will be given.

*Dubious Conclusion Respecting Deferred Income for Authors.*

The ruling with respect to authors furnishes a fertile source of subjects for tax philosophers of the "where will it all end" school.

To illustrate the uncertain scope of the ruling, let us assume that *A* owns a building suitable for use as a department store and leases it to *B* for sums to be computed by reference to *B*'s gross or net income from his store. However, the lease also provides that if the lease payments would otherwise amount to more than \$5,000 a year, the lessee is required to set the excess aside for payments to the lessor after the lease expired, in the same manner as the royalty arrangements in the example given in the ruling.

Would deferment be approved? Possibly not, but it is very difficult to see a distinction between the cases.

There are other questions. Suppose *T*, an attorney, works for six months on a case and has such a successful termination of the litigation that he earns a fee of \$30,000. He is on the cash basis and would like to have the fee spread over several years; he cannot spread the fee over back years because he did no work then and hence cannot qualify for the advantageous treatment afforded under section 1301. The client is willing to spread payment. Should it be said that the attorney has income of \$30,000 in the year the services were rendered where the client actually pays him over a period of years?

In the first place, the regulations would attribute the income to him if it were credited to his account or set aside for him.<sup>31</sup> Assume, however, that he just tells the client to pay him the money in five equal installments, and the money is never set aside in any sense. There is then no constructive receipt under the regulation, and it is certainly arguable that such a deferred compensation arrangement should be approved.

<sup>31</sup> Treas. Reg. § 1.451-2(a) (1957). Note that this appears inconsistent with and may be overruled by Examples 1 and 2 of the Ruling, in which the employer put funds representing deferred compensation in a separate account for the employee.

It cannot be said, however, that this course is without danger. If a man has constructive receipt of interest because he can reach out and take it, but fails to do so,<sup>32</sup> courts may be inclined to say that an attorney who can collect a fixed fee from a client but fails to do so likewise has constructive receipt of income. (However, it should be remembered that the ruling makes it clear that the mere fact that a debtor was willing to pay the creditor at an earlier date is not relevant in determining the success of a deferred compensation arrangement.<sup>33</sup>)

How might *T* best avoid the danger of constructive receipt in these circumstances? In the first place, he should be sure that there was no trust imposed on the fee. This would create immediate tax consequences to the client in any kind of deferred compensation arrangement, as the ruling makes clear. Secondly, he assuredly could avoid receipt—even if he were on the accrual basis—if he and the client did not set a final fee for the services but the client merely paid him sums on account. (It may be understood that practicability of this course is doubtful.) Assuming that the amount was not fixed except as to sums actually agreed upon and paid annually, there could be no income.

Another way of postponing income would appear to be to make the payment conditional. A conditional obligation can scarcely create income because the potential recipient has no vested right in it: he must refrain from serving others, giving advisory services or the like to earn the money at the later date.<sup>34</sup> The practicability of this device is likewise—at a minimum—doubtful.

<sup>32</sup> Interest is said to constitute income to a cash basis taxpayer as soon as it is available. Alexander Zolotoff, 41 B.T.A. 991 (1940); Edward Mallinckrodt, Jr., 38 B.T.A. 960 (1938). [Under Treas. Reg. § 1.451-2(b) (1957) an exception is made where it is shown that no funds for payment of interest were available.] The same conclusion has been reached with respect to matured bond coupons, even though the taxpayer was physically unable to clip and cash the coupons on the day the interest became available. *Loose v. United States*, 74 F.2d 147 (8th Cir. 1934); Treas. Reg. § 1.451-2(b) (1957). This regulation also provides with respect to corporate payments to its security holders (including shareholders) that “. . . if the amount of . . . interest is not available for the shareholders' free and unrestricted use at the time credited, such amount is not constructively received and does not constitute income to the shareholder until the taxable year in which the amount is available.” It also provides: “Interest on savings bank deposits is income to the depositor when credited on the books of the bank, even though the bank has a rule, seldom or never enforced, that it may require a certain number of days' notice before withdrawals are permitted. Generally, the amount of dividends or interest credited to shareholders of organizations such as building and loan associations or cooperative banks, is income to the shareholders for the taxable year when credited.”

<sup>33</sup> See note 17 *supra*.

<sup>34</sup> Indeed Treas. Reg. § 1.451-2(a) (1957) recites that there is no constructive receipt if taxpayer's control is “subject to substantial limitations or restrictions.”

There is still another problem. Suppose a publisher set up on his own books an account for the author; that is, he segregated the funds. This might run afoul of the regulation attributing constructive receipt where property is set aside for the ultimate recipient. In the author-publisher case in the ruling it was emphasized that the publisher was not authorized to segregate the sums in any manner.

Certainly this portion of the ruling is bound to invite experimentation on the part of tax counsel. There is no logical reason why deferment of salary should be easier than deferment of fees, rents, royalties, interest or other income from property. A ruling recognizing the propriety of deferment of royalties, coupled with the alternative methods of insuring successful tax deferment discussed in the preceding paragraphs, is bound to stimulate activity throughout the entire spectrum of income items, to the probable embarrassment of tax administration.

#### *Failure To Integrate Ruling With Other Types of Deferred Compensation*

One critical factor which a student attempting to evaluate this ruling must remember is that informal deferred compensation is only a part of the entire treatment of deferred compensation arrangements. With this in mind, it should be noted that the ruling represents substantial concessions in legitimizing taxpayer devices with respect to informal deferred compensation which formerly had been dubious.

1. It is clear that informal deferred compensation devices will be effective to postpone income until the sums are actually received by the employee, even in cases where postponement of such payment is not subject to conditions (such as that the employee will not compete with the employer, or will render consultative services, and the like).

2. It is now clear that the mere circumstance that the employer might willingly have made an earlier payment is irrelevant. (This had been thought to be the law previously; the ruling seems to make it explicit.)

3. In at least some cases (such as the *Oates* case) deferred compensation arrangements may be made even after earlier arrangements calling for payment on a specific earlier date have been crystallized.

4. Deferred compensation arrangements with respect to income from royalties (possibly including income from sale of literary property) are approved. It is not possible to tell whether this ruling would extend to deferment of rentals and interest. Still less is it possible to tell the extent, if any, to which the ruling will apply profits from the sale of property generally. It seems safe to assume that the ruling was intended to be limited, but the scope of the ruling is not drawn with certainty.

5. An employer now is permitted in informal deferred compensation arrangements to—in effect—fund deferred compensation reserves on his books, investing the proceeds paid to the appropriate accounts in securities or other investments which will protect the employee who is to be the ultimate recipient from inflation.

It may well be questioned whether this expansion of permissible devices for informal deferred compensation is wise in view of the general statutes which authorize certain tax advantages in deferred compensation cases under Internal Revenue Code, section 401 ff. The legislative history behind those statutes and the statutes themselves reflect the view that benefits of deferment should be generally available to substantial segments of the working staff of the employer without discrimination among the members of the group with respect to contributions received by them or their obligation to contribute. The statute further requires that an entire deferred pension plan be set up in considerable detail with absolute payments to be made to the plan by the employer, which under no circumstances may be returned to him.

As distinguished from this statutory structure, we now have a combination of judicial pronouncements and administrative rulings under which deferment of compensation is authorized in far different circumstances. In the plans now expanded by the ruling an employer can select whomsoever he pleases to receive benefits of deferred compensation; he can choose several persons and discriminate in any manner between them; he is not only not required but is forbidden to make payments into a trust fund or use a similar device so that the employee can rely on something more than the mere general credit of the employer. (It is true that under informal deferred compensation arrangements an employee who ultimately receives payment cannot get capital gain treatment of his deferred compensation, as he might if he received such payments through a qualified plan under Internal Revenue Code, section 403 (a), and that a deduction of the employer under

the informal plan is deferred until payment is actually made to the employee.)

The informal deferred compensation arrangements now encouraged by the ruling may be compared with still another device authorized at Internal Revenue Code, section 421 under which stock options are given to executives. These are like informal deferred compensation arrangements in that tax benefits are available whether they are given with or without discrimination to those whom the corporation desires to benefit. Here, as in the case of pension plans, compensation is deferred and, when received, is taxed at capital gain rates. Of course, in the stock option device (Int. Rev. Code, § 421) the employer gets no deduction for the additional compensation given to the employee; in deferred compensation arrangements such a deduction is available. Consequently, it may be expected that the ruling will tend to shift executive compensation devices away from stock options and over toward informal deferred compensation.

### *Summary*

This ruling is like other rulings of general application, regulations, and statutes, in the sense that it sets permissible limits respecting the tax consequences of various types of transactions. It is like other rulings also in that it doubtless resulted from strong taxpayer (and perhaps congressional) pressures. Certainly it may reasonably be argued that the ruling is subject to criticism: as necessarily follows in many cases of this kind it may raise at least as many questions as it has answered, and perhaps it goes too far in authorizing alternative methods of tax deferment to those specifically outlined by statute with respect to pension plans and stock options.

As to these points, however, subjective views of the propriety of the ruling are of relatively minor concern. Its major significance lies in a deep-seated malaise current in all tax legislation and interpretation, past and present: Congress, courts, administrators and the public are still drifting, dreaming and hoping that a rational approach to tax legislation and administration will come to us.

For it must be clear that we do not here merely measure, for example, the scope of the doctrine of constructive receipt. Whatever the effect of citing cases and regulations may be, the effect of the ruling obviously is—on a policy basis—to expand the scope of permissible arrangements for deferring compensation in order to

secure tax savings. We see here again a refusal to recognize fairly and openly that tax results are not shaped by legal dogma but are decided day to day on the basis of such social, economic and political pressures as are brought to that branch of government which makes the decision. The major fault of this ruling is the fault of decisions in general in tax matters: a refusal to express the motivation for the decision in terms of basic—not legalistic—requirements of our taxing system.

In short, this is a policy decision, but where is the policy? To find the answer, at least these questions must be answered:

1. Did the representatives of the Service simply get weary of resisting taxpayers' pressures?
2. Is there a sound basis, social, fiscal or economic, for expanding an alternative for deferred compensation to those given by statute?
3. If so, what is the basis?
4. On what basis is the line between permissible and prohibited expansion of the device to be drawn?

Answers to such questions should be given us by Congress when laws are written, by administrators when rulings and regulations are adopted, and by courts who often substitute conceptualism for a discussion of the realities of tax administration.

We cannot change overnight, but change we must. In the case at hand, if it was decided by personnel of the Internal Revenue Service that its position was right but could not practicably be supported in the courts, ideally the Service should have so stated, withdrawn from its previous position, and sought legislation. If it was decided that their position was wrong and that they should withdraw from it, ideally they should have explained why they withdrew. Until explanations of this sort are made by the Service (and until Committee Reports of Congress include a rational justification for the law in terms of tax economics and social requirements) taxing statutes, regulations and rulings can hardly rise above a congeries of compromises.

The nature of democracy is that an uneasy accord must sometimes be made between what is just and what is possible. This we cannot avoid, but if we are ever to put tax law to the level of adopting what is logical, workable and fair, we cannot fall below a minimum standard of boldness. Those who make our laws and those who interpret them by regulation, ruling, and decision must be courageous enough to acknowledge and defend the factors which

motivate their policy decisions. When a pattern for this conduct is established, a long step forward will be taken toward bringing our tax structure back to a realistic, fair and logical adjustment of the burden of each citizen to support his government. It must now be clear that this result can never be reached by piling palliative upon palliative, long retreats upon short advances, and the traditional silence respecting basic policy decisions of all branches of government controlling the day-to-day adjustment of our taxing statutes.