

VOLUNTARY PAYMENTS TO WIDOW OR BENEFICIARIES OF DECEASED EMPLOYEES

GRANT S. RICHARDS*

The possibility that a substantial payment of money made by a company to the widow or beneficiary of a deceased employee may be deductible for income tax purposes by the company, and tax free to the widow or beneficiary, makes this subject one of considerable interest to taxpayers. Furthermore, the volume of current cases on this subject is sufficiently large and the divergence of judicial opinion so marked as to make this a subject of timely and continuing interest to the practitioner.

We are here concerned only with the more recent developments in the tax treatment of voluntary payments made to the estate or beneficiaries of a deceased employee, as distinguished from payments made pursuant to a contract (express or implied),¹ or payments of amounts in which the deceased employee had a nonforfeitable interest under a qualified profit-sharing, pension or stock bonus plan, or under some other form of nonqualified deferred compensation arrangement. Section 101(b) of the Internal Revenue Code of 1954 provides for a \$5,000 exclusion from gross income for amounts received by the estate or beneficiaries of a deceased employee if paid by reason of the death of the employee, except for amounts in which the employee had, immediately prior to death, a nonforfeitable right to receive while living. An exception to the exception is provided with respect to amounts paid under certain qualified profit-sharing, pension or stock bonus plans, even though nonforfeitable, which are entitled to the \$5,000 exclusion.²

Except for payments deemed to be gifts and except for amounts qualifying for the \$5,000 exclusion, all other payments would be income and would qualify as income in respect of a decedent,³ the treatment of which is beyond the scope of this article.

* Partner, Law Firm of Knepper, White, Richards, Miller & Roberts, Columbus, Ohio; Member, Tax Section of the American Bar Association.

¹ A contractual obligation to make such payments may be implied from an established practice of the employer in making such payments or from the adoption of a plan to do so. In such case, the payments, subject to the \$5,000 exclusion provided by § 101(b)(2)(A) of the Internal Revenue Code of 1954, constitute taxable income. *Bausch's Estate v. Comm'r*, 186 F.2d 313, 40 Am. Fed. Tax R. 61 (7th Cir. 1951).

² Int. Rev. Code of 1954, § 101(b)(2)(B).

³ Int. Rev. Code of 1954, § 691. *O'Daniel Estate v. Comm'r*, 173 F.2d 966, 37 Am. Fed. Tax R. 1249, 49-1 U.S.T.C. ¶ 9235 (2d Cir. 1949).

For a more comprehensive treatment of the background of this subject there have been published several excellent articles.⁴ Let us examine the tax treatment of the voluntary payment as to both the payee and the payor.

TAX TREATMENT OF AMOUNTS RECEIVED BY WIDOW

For ease of reference we shall refer to payments received by the widow. This is not to suggest that payments received by other beneficiaries should be treated differently. The general problem arises in distinguishing whether the payment is a gift, and therefore excluded from gross income,⁵ or a non-donative payment of some kind which is included within gross income and so taxable.⁶

In the recent case of *Commissioner v. Duberstein*,⁷ the Supreme Court made a rather comprehensive analysis of the concept of "gift," as distinguished from a non-donative payment, for federal income tax purposes. The *Duberstein* case did not involve a voluntary payment to the beneficiary of a deceased employee, but involved the presentation of a Cadillac in appreciation for certain customer information provided to the "donor" company by the "donee" of the Cadillac. The Court pointed out that the concept of "gift" as used within the meaning of the Internal Revenue Code is not the same as used in the common law sense, but is used in a more colloquial sense; that the mere absence of a legal or moral obligation to make a payment does not establish that it is a gift. If a payment proceeds "from the incentive of an anticipated benefit of an economic nature" it is not a gift within the meaning of the Internal Revenue Code, said the Court. For the payment to be a gift it must proceed from a detached and disinterested generosity arising out of affection, respect, admiration, charity or like impulse.

The full impact of the *Duberstein* case on the tax treatment of voluntary payments to widows of deceased employees is yet to be felt. Shortly after the *Duberstein* decision, the Tax Court decided the *Pierpont* case.⁸ In *Pierpont* the company voluntarily paid

⁴ See e.g., Diehl, "Payments To Widows of Corporate Employees; Recent Cases and Rulings," So. Calif. Tax Inst. 491 (1960).

⁵ Int. Rev. Code of 1954, § 102(a). "General Rule—Gross Income does not include the value of property acquired by gift, bequest, devise, or inheritance."

⁶ Int. Rev. Code of 1954, § 61(a). "General Definition—Except as otherwise provided in this Subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, and similar items; . . ."

⁷ 363 U.S. 278, 5 Am. Fed. Tax R.2d 1626, 60-2 U.S.T.C. ¶ 9515 (1960).

⁸ Estate of Mervin G. Pierpont, 35 T.C. No. 10 (1960).

to the widow of the deceased employee an amount equal to one year's salary of the deceased employee, paid in monthly installments over a period of approximately thirty-three months. The Tax Court held the payments to be a continuation of salary, taxable as income, and not a payment intended to be a gift. In so holding, the court seemed to ignore the objective issues involved in these kind of cases and never really came to grips with the fundamental problems. The Tax Court based its decision on the broad generalized language of the *Duberstein* opinion, and in so doing seemed to take the position that any continuation of salary payments to the beneficiaries of a deceased employee constitute taxable income, except for the \$5,000 statutory exclusion. As pointed out by Judge Kern in his dissent, the *Duberstein* decision did not so hold; the problem is still a factual one, and *Duberstein* did not overrule all prior authorities on this subject. In the case of *Ivan v. Nickerson*,⁹ also decided by the Tax Court, the court did not need to resort to *Duberstein* to find that voluntary payments to the beneficiaries of a deceased employee were in fact a disguised distribution of earnings and profits. At least the Tenth Circuit Court of Appeals has not been stampeded by the *Duberstein* decision. In affirming the District Court of Colorado in the case of *Kasynski v. United States*,¹⁰ that court rejected the argument that a corporation in making payments to the widow of a deceased employee may not have the personalized feelings to make a gift as required by the *Duberstein* case. Thus, *Duberstein* has not eliminated the basic problem.

The basic problem is somewhat obscured. The Internal Revenue Code has long contained a specific exclusion from gross income with respect to amounts paid by the employer to a beneficiary of a deceased employee. Under the 1939 Code, amounts received by a beneficiary by reason of the death of the employee, if paid pursuant to a contract, were excluded from gross income.¹¹ The exclusion was limited to \$5,000 for any one employer.¹² The counterpart of section 22(b) of the Internal Revenue Code of 1939 is section 101(b) of the

⁹ 19 CCH Tax Ct. Mem. 1508, 29 P-H Tax Ct. Mem. 1671 (1960).

¹⁰ 284 F.2d 143 6 Am. Fed. Tax R.2d 6060 (1959), *aff'd*, 6 Am. Fed. Tax R.2d 5917 (10th Cir. 1960).

¹¹ Int. Rev. Code of 1939, § 22(b). "Exclusions from Gross Income—"The following items shall not be included in gross income . . . , (1) . . . amounts received . . . (B) under a contract of an employer providing for the payment of such amounts to the beneficiaries of an employee, paid by reason of the death of the employee; . . ."

¹² Int. Rev. Code of 1939, § 22(b)(1)(B). ". . . The aggregate of the amounts excludable under subparagraph (B) by all the beneficiaries of the employee under all such contracts of any one employer may not exceed \$5,000.00."

1954 Code. Under the 1954 Code, the requirement that the payment be pursuant to a contract was eliminated, and the \$5,000 limitation on the exclusion was made applicable to any one employee rather than to payments made by any one employer.¹³ It remains to be seen, as will be pointed out later in this article, whether Congress intended any more fundamental changes than the two mentioned above.

Initially, the Commissioner of Internal Revenue followed a rather liberal policy and treated payments made to widows of deceased employees "without enforceable obligation" as gifts and not income.¹⁴ His position seemed to be predicated on the widow or payee having rendered no service to the employer company in exchange for the payment. By 1950 the Commissioner had become less liberal in his policy as to these payments, and announced that irrespective of a plan, and whether the payments were voluntary or involuntary, or definite or indefinite, they would, if "in consideration of services rendered by the employee" be taxable income of the widow.¹⁵ Here the Commissioner's position seems to have been predicated upon the payor company having received services. I.T. 4027 did not meet with much success and was rejected by the Tax Court in the case of *Helstrom v. Comm'r*.¹⁶ In holding that the voluntary payments in that case were gifts and not income, the court set forth as controlling factors: (1) that the payments were made to the widow rather than the estate; (2) that the corporation had no obligation to pay additional compensation to the deceased employee; (3) that the corporation received no benefit from the payment; (4) that the widow performed no services for the corporation; (5) and that the husband's services had been fully compensated.

In 1958 the Commissioner, as a matter of litigation policy, announced that as to cases arising under the 1939 Code, voluntary payments to beneficiaries would be treated as gifts unless there was clear evidence that the payments were intended as additional compensation or as dividends.¹⁷

The cases under both the 1939 and the 1954 Internal Revenue Code, indicate that widows have been extremely successful in

¹³ Int. Rev. Code of 1954, § 101(b)(2)(A). "Employee Death Benefits—(1) General Rule.—Gross income does not include amounts received (whether in a single sum or otherwise) by the beneficiaries or the estate of an employee, if such amounts are paid by reason of the death of the employee. (2) Special Rules for Paragraph (1).—(A) \$5,000.00 Limitation.—The aggregate amounts excludable under paragraph (1) with respect to the death of any employee shall not exceed \$5,000.00."

¹⁴ I.T. 3329, 1939-2 Cum. Bull. 153.

¹⁵ I.T. 4027, 1950-2 Cum. Bull. 9.

¹⁶ 24 T.C. 916 (1955).

¹⁷ Rev. Rul. 58-613, 1958-2 Cum. Bull. 914.

establishing that voluntary payments were gifts to them and not taxable income.¹⁸ An analysis of these cases does not reveal any consistent objective factual pattern from which a clear-cut legal principal can be established. In the cases cited (in all of which the payments were held to be gifts), the amount of the payment ranged from \$50,000 to less than \$5,000. The relationship of the payment to the salary of the deceased employee ranged from the equivalent of three months' salary to three years' salary. In some cases the employer company followed a plan of making voluntary payments to others, in some they did not. In some cases the deceased employee owned a controlling stock interest in the employer company, and in some he owned no stock. In some cases the payee was a stockholder, and in some not. In only one case was the payee also an employee of the company in her own right.¹⁹

In the case of *Reed v. United States*,²⁰ the government made a new attack in an attempt to hold the voluntary payments to be taxable income, and by this attack has suggested that there has been a fundamental statutory change as a result of the enactment of section 101(b) of the Internal Revenue Code of 1954. As was pointed out, section 22(b) of the 1939 Code was entitled "Exclusions from Gross Income."²¹ The counterpart in the 1954 Revenue Code is section 101(b) and is entitled "Employee's Death Benefits."²² In the *Reed* case the Commissioner belatedly took the position that by the enactment of section 101(b) of the Revenue Code, Congress was addressing itself to *all* death benefit payments, and that regardless of the nature of such payments, any amount over \$5,000 would be taxable as income to the payee. In holding for the taxpayer, the court rejected the Commissioner's argument, and it seems rightfully so. It does not appear from the change in the statute that Congress intended to do more than eliminate the contractual provision contained in the 1939 Code, and to limit the \$5,000 exclusion to one employee. How-

¹⁸ *United States v. Kasynski*, *supra* note 10; *Neuhoff v. United States*, 1 Am. Fed. Tax R.2d 1702, 58-1 U.S.T.C. ¶ 9506 (S.D. Fla. 1958); *Friedlander v. United States*, 1 Am. Fed. Tax R.2d 620, 58-1 U.S.T.C. ¶ 9182 (E.D. Wis. 1958); *Rodner v. United States*, 149 F. Supp. 233, 50 Am. Fed. Tax R. 1952, 57-1 U.S.T.C. ¶ 9392 (S.D.N.Y. 1957); *Flora B. Slater*, 51 Am. Fed. Tax R. 1677, 56-2 U.S.T.C. ¶ 9892 (S.D. Calif. 1956); *Baur v. United States*, 51 Am. Fed. Tax R. 1353, 57-1 U.S.T.C. ¶ 9210 (S.D. Ind. 1956); *Estate of Arthur W. Hellstrom*, 24 T.C. 916 (1955); *Alice M. McFarlane*, 19 T.C. 9 (1952); see also *Estate of Frank J. Foote*, 28 T.C. (1957); *Louise K. Aprill*, 13 T.C. 707 (1949).

¹⁹ *United States v. Kasynski*, *supra* note 10.

²⁰ 177 F. Supp. 205, 3 Am. Fed. Tax R.2d 719, 59-1 U.S.T.C. ¶ 9264 (W.D. Ky. 1959), *aff'd*, 277 F.2d 456 (6th Cir. 1960).

²¹ Int. Rev. Code of 1939, § 22.

²² Int. Rev. Code of 1954, § 101(b).

ever, it must be admitted, that there has been a change in emphasis. Under the 1939 Code the emphasis was on the character of the payment, regardless of the number of such payments; under the 1954 version, the emphasis is on the amount rather than the character of the payment. After the Sixth Circuit affirmed the decision in the *Reed* case, the Commissioner announced his nonacquiescence.²³ In accord with the *Reed* decision is *Cowan v. United States* decided by the District Court of Georgia.²⁴ It is understood that counsel for the government has decided not to appeal the *Cowan* decision and thus place in issue within the Fifth Circuit the Commissioner's announced policy with respect to the *Reed* case. There is, by way of dictum only, some support for the Commissioner's position taken in the *Reed* case. In the *Bounds* case the court said:

While this controversy arises under the Internal Revenue Code of 1939 the law has now been amended and the problem with which we are here concerned cannot arise in the future. The new law rejects the tests which have been found unsatisfactory in practice and unequivocally makes non-taxable payments to the employee's estate or family, made by reason of his death, but it imposes a \$5,000 limitation.²⁵

This issue was squarely before the Tax Court in the *Pierpont* case²⁶ but the court side-stepped it completely.

Therefore, we have two schools of thought as to whether the Internal Revenue Code of 1954 has made a substantive change in the taxability of voluntary payments. On the one hand is the decision of the Sixth Circuit in the *Reed* case supported by the District Court of Georgia; on the other, the position of the Commissioner of Internal Revenue supported by dictum in the *Rodner* case (United States District Court for the Southern District of New York), and the *Bounds* case (Fourth Circuit Court of Appeals). A third possible treatment of these payments is as a distribution of earnings and profits rather than as a gift or some form of compensable income. Several cases have held voluntary payments to be gifts even though the deceased employee owned a controlling stock interest in the employer company. However, in a recent Tax Court memorandum decision,²⁷ the Commissioner successfully attacked the voluntary continuation of the father's salary which was paid to his five sons over a period in

²³ T.I.R. No. 252 (Sept. 12, 1960).

²⁴ 6 Am. Fed. Tax R.2d 5499, 60-2 U.S.T.C. ¶ 9674 (N.D. Ga. 1960).

²⁵ *Bounds v. United States*, 262 F.2d 876, 3 Am. Fed. Tax R.2d 389 (4th Cir. 1958).

²⁶ *Estate of Pierpont*, *supra* note 8.

²⁷ *Ivan v. Nickerson*, *supra* note 9.

excess of two years, the sons being the beneficiaries of the father's estate and succeeding to his stock in the company. Where the facts warrant such a decision, the Commissioner will probably enjoy more success in this area. It would also seem to follow that if the payments are held to be a disguised distribution of earnings and profits in the form of dividends, the \$5,000 exclusion provided by section 101(b) would not apply.

TREATMENT OF VOLUNTARY PAYMENTS BY EMPLOYER

Under the Internal Revenue Code of 1939 such payments were treated as "ordinary and necessary business expenses."²⁸ I.T. 3329 issued in 1939²⁹ ruled that the voluntary payment of death benefits was deductible to the corporation as a business expense within certain limits. The Treasury Regulations issued under the 1939 Code provided:

When the amount of salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition for the services rendered by the individual, such payments may be deducted³⁰

The limitation as mentioned in the Regulations and by the Commissioner in his publications seemed to revolve around the amount and the duration of the payment. In the case of *I. Putnam, Inc.*,³¹ the Tax Court approved continuing voluntary payments equivalent to the salary of the deceased employee for a period of twenty-four months. This limitation, both as to amount and time, seemed to constitute a rule-of-thumb as to the amount deductible by the corporation as a trade or business expense.

In 1954 the Commissioner seemed to shift his position from the "limited period" concept to that of the "reasonableness of total compensation." In Revenue Ruling 54-625,³² the Commissioner allowed the deduction of an amount equivalent to one year's salary of the deceased employee, the payment of which was to be spread over twelve years. The Tax Court in *Fifth Avenue Coach Lines, Inc.*,³³ considered the payment of an amount equivalent to approximately two and a half years' salary paid to the widow over a period of five years. The court found that the deceased employee had been under-

²⁸ Int. Rev. Code of 1939, § 23.

²⁹ I.T. 3329, 1939-2 Cum. Bull. 153.

³⁰ Treas. Reg. § 39.23(a)-9.

³¹ *I. Putnam, Inc.*, 15 T.C. 86 (1950).

³² Rev. Rul. 54-625, 1954-2 Cum. Bull. 85.

³³ 31 T.C. 1080, *aff'd on other grounds*, 281 F.2d 556 (2d Cir. 1960).

paid during bad times and that the payments made to the widow were a combination of gifts to her and additional compensation.

In the enactment of the Internal Revenue Code of 1954, section 162 became the counterpart of the old section 23(a). However, section 23(p)(i) of the 1939 Code pertaining to the payment of deferred compensation was not re-enacted as a subsection of section 162, but was contained in a new section 404 of the Internal Revenue Code of 1954 dealing with deductibility of deferred compensation generally.³⁴ If a payment can be deducted as a trade or business expense under section 162, it can be accrued and taken as a deduction by an "accrual basis" taxpayer. On the other hand, under section 404(a)(5), a deduction may be taken only in the year of actual payment regardless of the system of accounting used by the employer taxpayer. The Commissioner has now taken the position, both by Regulation³⁵ and otherwise, that all payments made to widows or beneficiaries of a voluntary nature are the equivalent of additional compensation to the employee under a deferred plan and hence only deductible in the year when actually paid.³⁶

THE SAME PAYMENT AS CONSTITUTING A GIFT TO THE WIDOW AND
AN ORDINARY AND NECESSARY BUSINESS EXPENSE TO THE
CORPORATION

The present state of law seems to indicate that a given payment can be treated as a gift to the widow or beneficiary (hence excludable from her income) and the payment of an ordinary and necessary business expense by the company (hence deductible by the company for tax purposes).

There are those who maintain that once the nature of a payment has been established, the treatment of it should be uniform for all purposes and as to all taxpayers. The Supreme Court of the United States, in a 5-4 decision, held that the payment of the same amount cannot be both a gift and compensation.³⁷ In a strong dissent in that case, Justices Brandeis, Stone, Cardozo, and Black pointed out that, "The Categories of gift and compensation are not always mutually exclusive, but can at times overlap."

³⁴ Int. Rev. Code of 1954, § 404.

³⁵ Treas. Reg. § 1.404(a)-12 (1956). ". . . Similarly, if amounts are paid as a death benefit to the beneficiaries of an employee (for example, by continuing his salary for a reasonable period) and if such amounts meet the requirements of Section 162 or 121, such amounts are deductible under Section 404(a)(5) in any case when they are not deductible under the other paragraph of Section 404(a)."

³⁶ *Champion Spark Plug*, 30 T.C. 295, *aff'd*, 266 F.2d 347 (6th Cir. 1959), *non-acq.*, 1958-2 Cum. Bull. 9.

³⁷ *Bogardus v. Comm'r*, 302 U.S. 34, 19 Am. Fed. Tax R. 1195, 37-2 U.S.T.C. ¶ 9534 (1937).

The Tax Court in *Fifth Avenue Coach Lines, Inc.*,³⁸ found that voluntary payments could be gifts on the one hand but nevertheless deductible by the corporation as a necessary business expense. Seldom are both issues before a court in the same case. Furthermore, this question has not been placed in issue because the Commissioner has failed to question the deduction in those cases wherein he sought to tax the payments to the widow as income. There is no assurance that the Commissioner will continue this practice.

If one is unable to accept the "dual nature" of these payments and concludes that what is a gift to the payee must also be a gift by the payor company, the Commissioner will have yet another avenue of attack, which as yet he has not taken in any of the reported cases. This relates to the gift tax and constructive receipt of dividends question. While the gift tax statute contemplates that gifts will be made only by individuals,³⁹ the Regulations provide that a transfer by a corporation by way of gift constitutes a gift by the shareholders of the corporation, and that if the donee is also a shareholder, it is a gift to him by the other shareholders, unless the transfer is deemed to be a distribution of earnings and profits or a distribution in liquidation.⁴⁰ Assuming the validity of this Regulation, this would mean that in all cases where the voluntary payment was held to be a gift by the corporation, it would then be deemed to be a gift by the shareholders of the corporation and that if that portion of the gift allocated to any shareholder would exceed \$3,000, the excess could constitute a taxable gift, unless exempt under the donor's life time exemption. As a corollary, would it not also follow that if the shareholder has made a gift to the widow or beneficiary, it could only have been made out of a distribution of earnings and profits constructively received by the donor shareholder? If so, not only would the corporation lose the deduction but the donor shareholders would be liable for income tax on the dividend income constructively received. As a practical matter, the gift tax question involving shareholders would arise only in those cases wherein there would be a very closely held corporation and a rather substantial payment to the widow or the beneficiary. However, every case of a voluntary payment of this kind would involve serious consideration if the amount is to be allocated and taxed to the shareholders as dividend income under the constructive receipt theory. It isn't likely that we have seen the end of litigation on this question.

³⁸ *Supra* note 33.

³⁹ Int. Rev. Code of 1954, § 2501.

⁴⁰ Treas. Reg. § 25.2511(h) (1958). See also H.R. Rep. No. 708, 72d Cong., 1st Sess. 27 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 39 (1932).