Vanderbilt Law Review

Volume 13
Issue 2 *Issue 2 - March 1960*

Article 2

3-1960

Deferred Compensation Plans: Qualifying for Non-Qualified Treatment

James F. Neal

DEFERRED COMPENSATION PLANS: QUALIFYING FOR NON-QUALIFIED TREATMENT

JAMES F. NEAL*

I. INTRODUCTION

For an important number of people in our "affluent society," the problem of spreading large current earnings, and the federal income tax imposed thereon, over a number of years has taken on sizeable proportions. Only slightly helpful for some of these people are the deferred compensation provisions of sections 401 through 404 of the Internal Revenue Code of 1954 (hereinafter referred to as the Code).[1] Consequently, many highly paid executives must still resort to other arrangements. The purpose of this paper is to explore the present status, from an income tax standpoint, of those non-qualified arrangements between employers and employees which have as their object the deferring of compensation for current services. Much has been written on this subject,[2] but recent developments involving both funded and unfunded plans, as well as the increasing use of the latter, seem to make worthwhile a review of the current status of the law in this area in the light provided by its history.

To set the stage, qualified deferred compensation plans under section 401 of the Code, including the requirements for qualification and the tax consequences of the plans so qualified, will be discussed briefly.

II. QUALIFIED PLANS

Even prior to the 1942 amendment of the Internal Revenue Code of 1939, certain deferred compensation plans received preferred treatment. In the 1942 amendment, however, the statute was made much more explicit and considerably more restrictive.[3] Sections 401 to 404 of the Code of 1954 now contain the provisions relating to qualification for preferred treatment and the tax treatment once qualified. Section 401, the basic section, provides in essence that a pension, stock bonus or profit sharing plan of an employer to qualify must cover either a

* Associate, Turney & Turney, Washington, D.C.; former Editor-in-Chief, *Vanderbilt Law Review*.

1. Because of their stringent requirements the qualified pension, stock bonus and profit sharing plans of §§ 401-04 may not prove suitable to the highly paid executive. See TARLEAU, *The Problem of Compensating Executives*, PROC. OF THE TAX INSTITUTE OF SOUTHERN CALIFORNIA 149 (1953).
2. For a bibliography of articles in this field, see Fillman, *Ford Motor Company Employee Benefit Plans*, N.Y.U. 17TH INST. ON FED. TAX 883, 893 (1959). See also *Tax Notes*, 45 A.B.A.J. 1204 (Nov. 1959).
3. ALI BASIC PENSION AND PROFIT SHARING PLANS, 2 (1957).

definite percentage of employees[4] or such employees as are included in a classification set up by the employer and found by the Commissioner of Internal Revenue not to be discriminatory in favor of officers, supervisors or stockholder-employees;[5] must require that employer contributions pursuant to the plan and income earned from those contributions be for the exclusive benefit of the employees or their beneficiaries;[6] and must not discriminate in allocation of contributions or benefits in favor of officers, supervisors or employee-stockholders.[7] In addition to these statutory requirements for qualifications, the Internal Revenue Service has added other requirements by use of the word "plan."[8]

Trusteed plans meeting the requirements of section 401 have three primary tax benefits: the contributions of the employer are deductible in the year paid to the trustee;[9] the income from the trust is exempt from taxation;[10] and, generally, the beneficiaries are not taxed until distribution is made from the trust.[11] Qualified annuity plans have available two of the three benefits above, *i.e.*, deduction by employer of the amount of contribution in the year made and deferment of tax to beneficiaries until distribution.[12] Additional benefits are bestowed upon beneficiaries of qualified plans when distribution is made, such as exclusion from estate tax (section 2039(c)) and tax at capital gain rates where total distributions payable are paid within one taxable year to the beneficiary, by reason of the employee's death or other separation from service.[13]

4. Seventy per cent of all employees, or if seventy per cent or more of all employees are eligible to benefit, then eighty per cent of that seventy per cent. INT. REV. CODE OF 1954, § 401(a)(3)(A). As explained fully in the regulations, to determine the percentages above, the employer may exclude new employees, part time and seasonal employees. Thus, an employer may employ one hundred people but coverage of fifty of these may satisfy the seventy per cent rule if thirty of the employees are employed on a part time or seasonal basis.

5. INT. REV. CODE OF 1954, § 401(a)(3)(B).

6. INT. REV. CODE OF 1954, § 401(a)(2). Note that this section implies that some part of the contribution or the income therefrom may revert to the employer after satisfaction of all liabilities. The regulations explain this by saying that only amounts left over because of erroneous actuarial computations may be returned to the employer and that the trust instrument must contain a definite provision to this effect. Treas. Reg. § 1.401-2(b)(2) (1956).

7. INT. REV. CODE OF 1954, § 401(a)(4).

8. "Plan," says the Revenue Service, implies permanency and a written program communicated to the employees.

9. Generally, whether or not the employer uses the accrual basis of accounting. The contributions of the employer are deductible under § 404 and subject to the amount limitation thereof. They must not be unreasonable in amount, however, when collated with other deductible compensation to the individual employee beneficiaries paid under § 162.

10. INT. REV. CODE OF 1954, § 501(a).

11. INT. REV. CODE OF 1954, § 402(a).

12. INT. REV. CODE OF 1954, §§ 404(a)(2), 403(a).

13. INT. REV. CODE OF 1954, §§ 402(a)(2) and 403(a)(2). For an analysis of the tax consequences upon distribution from qualified plans and a criticism of some of the special benefits, see Sporn, *Taxation of Deferred Compensa-*

III. Non-Qualified Plans

As indicated in the introduction, the main thrust of this paper is directed generally to those funded "plans" which fail to qualify under section 401 or 403 and specifically to those "plans" which are not completely covered anywhere within the sections 401 through 404 simply because they are unfunded.

A. Funded Contracts

1. *Pre-1942.*—Prior to 1942, there were no specific statutory provisions taxing employee-beneficiaries, using the cash and disbursements method of accounting, on the contributions made by an employer pursuant to a contract deferring compensation.[14] The Revenue Service and the courts in certain instances, however, had reached the results later to be codified in the 1942 amendment to the Internal Revenue Code of 1939.[15] If the employee's rights under the funded contract were nonforfeitable in the years in which the contributions were made, the employee was taxed upon this amount in those years, notwithstanding the fact that he would receive no cash for several years.[16] In reaching this result, the courts sometimes used the constructive receipt doctrine,[17] but more often the economic benefit theory.[18]

In the leading case of *Renton K. Brodie,*[19] the employer set aside funds in 1934 to compensate employees for loyal service, but at this time the fund was no more than a bookkeeping entry and the employees had no rights whatever therein. In 1938, however, the employer took $25,000 out of the fund to purchase an annuity contract for petitioner, vesting all rights under the contract in petitioner in that year. In upholding the assessment upon petitioner for the tax

---

tion Arrangements, 14 Tax L. Rev. 289, 299 (1959).

14. See Senate Finance Comm., 77th Cong., 2d Sess., S. Rep. No. 1631 (1942).

15. *Ibid.*

16. Ward v. Commissioner, 159 F.2d 502 (2d Cir. 1947); 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); David Watson Anderson, 5 T.C. 1317 (1945); Paul A. Draper, 6 T.C. 209 (1946); Harold G. Perkins, 8 T.C. 1051 (1947).

17. "A taxpayer may not deliberately turn his back upon income and thus select the year for which he will report it." Hamilton National Bank of Chattanooga, 29 B.T.A. 63 (1933). The constructive receipt doctrine could be used where the employee could have had cash but asked the employer to obtain an annuity for him instead, Richard R. Deupree, 1 T.C. 113 (1942), or where the employee controlled the corporate employer and had it purchase an annuity instead of paying him cash for past services. Oberwinder v. Commissioner, 147 F.2d 255 (8th Cir. 1945), could have been decided under this doctrine.

18. The theory that compensation to be taxable need only be the equivalent of cash. Dudley T. Humphrey, 32 B.T.A. 280 (1935). As will be seen *infra,* it may be illogical to say that one promise to pay is equivalent of cash, but another equally safe is not.

19. 1 T.C. 275 (1942).

on $25,000 in 1938, the court stated that petitioner had received the "economic benefit" of the money expended in his behalf and was therefore taxable.

Generally, if the employee's rights were nonforfeitable in the year of the contribution, it made no difference that those rights had no cash surrender or loan value or were nonassignable;[20] but at least in one case taxability of the beneficiary in the year of contribution was held to turn upon the question of whether the rights were assignable in that year. This was the case of *Ward v. Commissioner*,[21] in which the court, finally deciding that the nonforfeitable rights were assignable in the year of the contribution, held that the employee-beneficiary was taxable on that amount in that year on the theory that he had received the equivalent of cash.

It appears that in one important aspect the pre-1942 law on taxability of beneficiaries of nonforfeitable rights differed from the law thereafter. In *K. R. Kingsbury*[22] employees' rights in a non-qualified trust had been forfeitable when the employer contributions had been made, and thus not taxable, but became nonforfeitable in 1926 giving them a life estate with a limited testamentary power of appointment. In 1927 the trust was terminated and the employees received the corpus. The court held that the employees were taxable in 1926 upon the present value of the life estate and the limited power of appointment, and in 1927, upon the difference in value between those two items and the value of the corpus. It is to be noted that the House version of the 1942 amendment to section 165(b) (now 402(b)) and section 22(b) (2) (B) (now 403(b)) incorporated the principle of the *Kingsbury* case and, if passed, would have made beneficiaries of funded contracts taxable on the employer contributions in the year the erstwhile forfeitable rights became nonforfeitable.[23]

On the employer's side, the pre-1942 law differed materially from what it is today. The contributions of the employer were deductible in the year made if they qualified as ordinary and necessary business expenses and if the amount contributed could not revert back to the employer, whether or not the rights of each individual employee were nonforfeitable.[24]

2. *Post-1942.*—In 1942 Congress amended section 165(c) (now section 402(b)) and section 22(b) (2) (B) (now 403(b)) to provide that

20. See, *e.g.*, Hackett v. Commissioner, 159 F.2d 121 (1st Cir. 1956).
21. 159 F.2d 502 (2d Cir. 1947).
22. 31 B.T.A. 1126 (1935).
23. See note 14 *supra*.
24. Wesley Heat Treating Co., 30 T.C. 10 (1958); Gisholt Machine Co., 4 T.C. 699 (1945); Phillip H. Lord, 1 T.C. 286 (1942). The court, in *Wesley Heat Treating Co.*, did not discuss the method of determining if the amounts were reasonable, and this would appear difficult if the rights could shift from one employee to another.

contributions by employers to non-exempt trusts and for non-qualified annuities are taxable to employee-beneficiaries in the year of the contributions if their rights are nonforfeitable in that year.[25] Since the statute provides that beneficiaries under non-exempt trusts and non-qualified annuities are to be taxed under section 402(b) and 403(b) and since these sections provide for taxation in the year of contribution only if the rights are nonforfeitable, it seems that the employees would not be taxed upon contributions if their rights were forfeitable during the year the contributions were made. This is the position taken by the Service in the regulations, section 1.402(b)-1(a)(2), and is undoubtedly the law unless changed by the case of *Elliot C. Morse*.[26]

In the *Morse* case the employer purchased an annuity contract for petitioner in 1941. It was understood by all concerned that petitioner was to receive the benefits under the contract when he retired, although the employer was the beneficiary and received the annual annuity payment during 1942. Petitioner retired in 1943 and received an assignment of the annuity contract. He reported as income in that year only the amount received from the insurance company as an annual payment and the Commissioner assessed a deficiency. Petitioner argued that under section 403(b) he was taxable on the employer's contributions for the annuity only if in the year made his rights were nonforfeitable and that since he did not have nonforfeitable rights in 1941 he was subject thereafter to a tax only upon the distributions. In upholding the Commissioner the Tax Court made a distinction between forfeitable rights and no rights and held that as petitioner had no rights in the contract in 1941, the contribution by the employer "for his benefit," within the meaning of section 403(b) occurred in 1943.

Except for possible difficulty in distinguishing, in every situation, between no rights and forfeitable rights, there would appear to be no inequity in the *Morse* case. Actually, the employer had done nothing more in 1941 than change the form of one of its own assets, *i.e.,* from cash to an annuity.[27] The contribution, therefore, was an annuity and occurred in 1943 when the employee's rights were nonforfeitable. Presumably the employer would be allowed to deduct the contribution in 1943 and thus, for this case, remove a real inequity which, as will be discussed below, may exist in the law at present.

---

25. Section 402(b) for non-exempt trusts and § 403(b) for non-qualified annuities.

26. 17 T.C. 1244 (1952), *aff'd,* 202 F.2d 69 (2d Cir. 1953). Of course they would be taxed upon distribution of the proceeds.

27. Apparently some writers have sensed a danger to unfunded contracts arising out of *Morse.* See Bergen, *Income Tax Aspects of Non Qualified Deferred Compensation Plans,* N.Y.U. 16TH INST. ON FED. TAX 91 (1958). See, however, Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).

As stated elsewhere in this article, prior to the year 1942 employer contributions to non-qualified deferred compensation plans were deductible under the general provisions of section 23(a) (now section 162) if they qualified as ordinary and necessary business expenses, whether or not the rights of each individual employee were forfeitable in the year of the contribution. Congress, in 1942, amended section 23(p) to provide that employer contributions to non-qualified plans are deductible only under this section and deductible in the year made if the employee's rights were nonforfeitable during that year. Provisions containing identical language were carried over into sections 404(a) and 404(a)(5) of the 1954 Code. Pursuant to these sections, the regulations, section 1.404(a)-12, state that if the employee's rights are forfeitable when contributions are made no deduction can ever be taken by the employer. Two important cases have arisen under the corresponding provisions in the 1939 Code and the courts have reached what seem to be diametrically opposite results. In *Wesley Heat Treating Co.*[28] the employer set up an irrevocable trust in the latter part of each year 1940 through 1946 and at the same time made a contribution to the trust, the amount depending upon profits estimated for the year. The trust instruments provided generally that payments from each trust were to be made to employees, if practical, in the year following the establishment of the trust; but that in any event all distributions were to be made and the trust terminated within three years. The trustees were given discretion in apportioning the distributions among the employees. In most cases the payments were actually made over two or three years following the institution of the trust. The court held that as to the trusts established prior to January 1, 1942, the contributions were deductible under section 23(a) (now section 162) as ordinary and necessary business expenses, but that as to the trusts established after that date no contributions were ever deductible since the individual rights of the employees were forfeitable in the year of the contribution. In so holding the court clearly passed upon the contention of the employer that as to the post-1942 trusts it was at least entitled to a deduction in the year of distribution.

The Court of Claims, in *Russell Mfg. Co. v. United States*,[29] held that the employer was not entitled to take a deduction for contributions to a non-qualified irrevocable trust in the year the contributions were made since the individual employee's rights were forfeitable in that year,[30] but that in the subsequent year, when the distribution of

28. 30 T.C. 10 (1958), *aff'd*, 267 F.2d 853 (7th Cir. 1959).

29. 175 F.Supp. 159 (Ct. Cl. 1959), *nonacq.* Rev. Rul. 59-383, 1959-1 CUM. BULL. 30.

30. It was established in William M. Bailey, 15 T.C. 468 (1950), *aff'd*, 192 F.2d 574 (3d Cir. 1951), that provision concerning nonforfeitability referred

the prior year's contribution was made, the employer was entitled to a deduction. The court stated that the legislative history of sections 23(p)(1) and 23(p)(1)(D) of the 1939 Code indicated a congressional intent to grant tax benefits to qualified plans but not to penalize unqualified plans, and that the clear language of these sections[31] provided that deduction may be taken in the year the contribution is made if the employee's rights are nonforfeitable or, if not, in the year the compensation is paid to the beneficiaries. In passing, the court stated, without giving reasons, that the *Wesley* case was distinguishable.

It is hard to see the clarity in these sections that impressed the court, and it seems that the court treated too cavalierly the argument of the Commissioner relating to the failure of Congress to pass a proposal which would have permitted a deduction in the year distributions were made to the beneficiaries. Nevertheless, except for the conceptual problem of allowing one entity a deduction for a payment made by another, particularly an irrevocable trust, it is difficult to argue with the essential fairness of the result reached in the *Russell* case. It was obviously Congress' intention to encourage the use of qualified plans by granting tax benefits not enjoyable under general tax principles. It seems unduly harsh, however, to penalize nonqualified plans by never allowing employers a deduction for ordinary and necessary salaries paid to employees. Furthermore, the language of sections 23(p)(1) and 23(p)(1)(d) of the 1939 Code is sufficiently ambiguous to permit the result reached by the court without it being guilty of judicial legislation. The rule of the *Russell* case brings the law more nearly in line with that existing prior to 1942 and seems to be altogether a desirable result. Of course, an employer would not be well advised at the present time to rely upon the *Russell* case as the Service has indicated its intention not to follow that decision.

B. Unfunded Contracts

One could conceive of numerous situations which would be covered under this subject. The contract may be to pay in later years for

---

to individual rights and not to the rights of a group.

31. Identical language in sections 404(a) and 404(a)(5) provides:

"If contributions are paid . . . to or under a stock bonus, profit-sharing or annuity plan, or if compensation is paid . . . on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall . . . be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

. . . .

"(5) OTHER PLANS—In the taxable year when paid, if the plan is not [qualified], if the employees' rights to or derived from such employer's contribution or such compensation are nonforfeitable at the time the contribution or compensation is paid."

services already performed at the time the contract is executed; it may be to pay over the next ten years for services performed in the next two; or it may be to pay stated annual amounts after a future retirement for a fixed number of years or for life.[32] There are elements common to all, however; a contract between persons having generally the relationship of employer and employee deferring compensation beyond the termination of the services which gave rise to the obligation to pay; and no current contributions by the employer to a trust or for an annuity, in which the employee has a beneficial interest, in order to fund the obligation.

The fundamental issues in each of these situations are whether the employee receives taxable income prior to actual payment, and if so, when. It should be emphasized again that sections 401 through 403 of the Code do not apply, and, indeed, there are no statutory provisions specifically applicable. Consequently, if cash basis taxpayers are to be taxed prior to the receipt of cash, the Revenue Service must, as it did prior to 1942 in the case of funded contracts, rely on the doctrines of constructive receipt and economic benefit in connection with the general provisions of section 61.

For a period of time the Internal Revenue Service fought a valiant but losing fight to tax employees under these contracts prior to the actual receipt of cash,[33] but in recent years it has been ominously inactive. It has been thought generally that the problem was being reviewed at high levels and that there was increasing pressure from the field offices for an announced policy. Around February 1 of this year, the Service issued Revenue Ruling 60-31[34] in which it appears to have capitulated to the taxpayers and the courts, at least within the defined limits set out in the ruling. The significance of this apparently unexpected development can be appreciated only by a brief review of the fight which proceeded it.

One of the early cases involving this subject was *William J. Hines*.[35] In that case, counsel were employed to settle an estate. Until the end of the year 1933, they had no right to any compensation; and prior to that time, a contract had been executed whereby the residuary legatee, a corporation, had agreed to pay the fee for their services within the next five years. Actually, payment was made equally over the next five years. In reversing the Commissioner's assessment of a deficiency for 1933, the court held that, since prior to the end of

32. See Casale v. Commissioner, 26 T.C. 1020 (1956), *rev'd*, 247 F.2d 440 (2d Cir. 1957), for a typical contract.
33. James F. Oates, 18 T.C. 571 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953); Howard Veit, 8 T.C. 809 (1947); William E. Freeman, 4 T.C. 582 (1945); Kay Kimbell, 41 B.T.A. 940 (1940); William J. Hines, 38 B.T.A. 1061 (1938).
34. Rev. Rul. 60-31, 1960 Int. Rev. Bull. No. 5, at 17.
35. 38 B.T.A. 1061 (1938).

1933 counsel were entitled to no compensation and that by the end of the year a binding contract prevented them from receiving it, the doctrine of constructive receipt did not apply. The court also held, apparently because the promise to pay was not easily transferable, that counsel could not be taxed in 1933 on the theory that they had received a taxable economic benefit in that year. It is to be noted that by the end of 1933 there were no contingencies or conditions in the way of counsel's ultimate receipt of the money.

It seemed apparent that the constructive receipt doctrine would be ineffective in this area if it could be avoided simply by having the employer and employee sign a binding contract deferring payment a short period before the employee, under the original contract, would be entitled to receive the money. In fact, the court in a later case modified its position in this regard. In *Howard Veit*,[36] where, again, the right to receive payment was unconditional in the year in question, the court was careful to point out that the prior contract deferring this compensation was a bona fide arm's-length bargain beneficial to both parties and intended to accomplish purposes other than the avoiding of taxes.

Application of the economic benefit theory was restricted in the *Hines* case to those situations involving a promise which was easily transferable. Three dissents in *William E. Freeman*[37] argued that this theory was not so restricted. In that case, the employer, in 1929, had promised to pay petitioner $12,000 a year for life and $8,000 a year to his widow for life if she survived him. The promise was said to be in consideration for "past, present and future services." By court order in 1939, the estate of the employer purchased annuities for petitioner in settlement of the 1929 obligation. Petitioner did not include the value of the annuities in his return for 1939, and argued in the Tax Court that since he had received an economic benefit in 1929, he should have paid a tax in that year, but that in 1939 he had only received one promise in lieu of another. In rejecting this argument, the court stated that in 1929 petitioner had received a "mere" promise to pay conditioned upon his satisfactory performance in the future. He was, therefore, taxable in 1939 upon the value of the annuities.

The three dissents, emphasizing that the rights under the 1929 promise became unconditional in 1930 when the employer died, agreed with petitioner that in 1939 he had merely received one promise of lesser value in lieu of another, both from solvent obligors. They would have reversed the Commissioner on the ground that the

36. 8 T.C. 809 (1947); Kay Kimbell, 41 B.T.A. 940 (1940).
37. 4 T.C. 582 (1945). See also Frederick John Wolfe, 8 T.C. 689 (1947), *aff'd per curiam*, 170 F.2d 73 (9th Cir. 1948).

tax should have been imposed in an earlier year.

One of the most recent cases is the 1952 case of *James F. Oates*,[38] in which insurance agents, electing to spread terminal commissions evenly over several years instead of receiving them as they ordinarily come, large in the first few years and declining thereafter, were assessed with a deficiency in the early years to the extent of the difference between the amount they actually received and the amount they would have received without the election. The election had to be made prior to retirement and was irrevocable once made. On appeal to the Tax Court the Commissioner was reversed. The court, citing *Veit* and *Kimbell*,[39] held that the agents had not constructively received the difference because the bona fide, binding contract, executed prior to the time the payments would have been due, placed limitations upon the availability of the money. The court scarcely considered the economic benefit theory, even though the agents' rights could be considered unconditional, although the amount was not capable of precise determination.

The case of *Casale v. Commissioner*,[40] while involving a question of dividend income, is pertinent because of the facts involved and the reasoning employed by the court. In that case, the corporation, 98% of whose stock was owned by taxpayer-employee, entered into a contract whereby the latter would continue to work for the corporation for a period of years, after which time he would receive a retirement pension provided that he did not compete, directly or indirectly, with the corporation. The corporation then purchased an insurance contract upon the life of the employee, retaining all incidents of ownership. Upon retirement of the employee, however, the insurance contract was to be converted automatically into an annuity, with payments going directly to the employee.[41] The court of appeals, reversing the Tax Court, held that the employee did not receive dividend income to the extent of the premiums paid by the corporation during the years prior to his retirement, since he had no rights in the contract. All he had was his contract with the employer under which he might receive compensation in the future.

Notwithstanding the fact that aside from the *Freeman* case the courts have not seemed to place too much importance upon forfeitability vis-a-vis nonforfeitability of rights under the contract, and notwithstanding the intonations that the doctrine of constructive

38. 18 T.C. 571 (1952), *aff'd*, 207 F.2d 711 (7th Cir. 1953). The recent ruling, Rev. Rul. 60-31, *supra* note 34, withdrew the prior non-acquiescence in this case and stated that the Service would now acquiesce.

39. See note 33 *supra*.

40. 247 F.2d 440 (2d Cir. 1957), *reversing* Oreste Casale, 26 T.C. 1020 (1956).

41. However, if the employee competed with the corporation without its consent, the annuity payments would have been diverted to the employer since it still held the right to change the beneficiary.

receipt is to be sparingly applied[42] and that a mere promise to pay an amount in the future is not the equivalent of cash,[43] lawyers have been careful to make the employees' rights under these contracts conditional as to each amount until the amount is actually received. The conditions commonly imposed are that the employee is to remain available for consultation and is not to compete with the employer. Such was the state of apprehension and uncertainty prior to February of this year.

In Revenue Ruling 60-31,[44] the Service ruled upon five factual situations, all involving cash-basis taxpayers. The first two involved contracts deferring compensation of employee-executives of the employer corporation. In both cases the contracts provided for stated salaries during a period of employment, with deferred payments to commence upon retirement or disability of the employee. Under both contracts, annual amounts during the period of employment were to be credited to accounts in the name of the employees and carried on the books of the corporation as liabilities. The corporation in neither case held the amounts as trustee for the employees, and the employees' rights against the employer were correspondingly limited to the contract. In the first situation, rights of the employees were nonforfeitable; in the second, the rights were subject to the usual conditions of remaining available for consultation and refraining from competition with the employer.

In the third situation the taxpayer, an author, and the corporation, a publishing company, executed two contracts simultaneously, the effect of which was to grant the corporation exclusive publishing rights to the author's book for a stated royalty, which was to be a percentage of the proceeds received by the publisher from the sales of the book. While the first contract provided for semi-annual payments, the second required the publisher to hold the excess over a stated annual amount and carry it forward to a subsequent accounting period. The publisher was not required to segregate or pay interest on the amount carried over.

In the fourth situation, the taxpayer was a professional football player who had signed a contract to play with a club for two years at a stated salary. In addition he was to be paid a bonus for signing the contract. Under the contract this bonus was to be placed with an escrow agent pursuant to an escrow agreement which provided that the amount deposited was to be paid out to the player in equal

42. William J. Hines, 38 B.T.A. 1061 (1938); Cecil Q. Adams, 20 B.T.A. 243 (1930), *aff'd*, 54 F.2d 228 (1st Cir. 1931); John A. Brander, 3 B.T.A. 231 (1925).

43. United States v. Christine Oil & Gas Co., 269 Fed. 458 (W.D. La. 1920); Dudley T. Humphrey, 32 B.T.A. 280 (1935); John B. Atkins, 9 B.T.A. 140 (1927).

44. Rev. Rul. 60-31, 1960 INT. REV. BULL. No. 5, at 17.

installments over a five-year period.

The last factual situation involved a boxer who had signed a contract with a boxing club, under which he was to participate in a fight for a percentage of the proceeds. Under the contract, 25% of the boxer's share was to be paid within three weeks of the fight and 25% was to be paid in each of the three years following the year in which the fight was staged.

In the first three cases, the Service held that the taxpayers would be subject to tax upon the deferred payments only in the year or years in which they were received. The economic benefit, or equivalent of cash, theory was ruled inapplicable on the ground that mere promises to pay were involved, not evidenced by notes or secured in any way. Ruling that the taxpayers would not be held to have constructively received the deferred payments, the Service gave effect to the contractual time limitations imposed by the parties themselves, without regard to motives and without regard to the fact that in two of the cases the money would be earned and completely vested prior to actual receipt. By its reasoning that "the statute could not be administered by speculation whether the payor would have been willing to agree to an earlier payment," and by acquiescing in the *Oates* case, the Service seems to be saying that for tax purposes it will recognize and give effect to contracts postponing the payment of income if executed prior to the time that the employee or independent contractor is entitled to receive the money, even though it has been earned at the time the contract is executed.

The Service distinguished the case of the football player and held him taxable on the bonus when paid to the escrow agent upon the sole ground that a fund had been physically segregated in which he had a specific interest. Time limitations, similar to those in the first three cases, having been imposed upon the player's receipt of the money, the Service was forced to rely upon the economic benefit theory. Applying this theory, it apparently reasoned that the removal of a specific fund from the control of the employer, and the exigencies of its business, bestowed upon the football player a benefit different in kind from that received by the promisee of a "mere promise to pay." As the escrow account was not a trust or an annuity, no direct reliance was placed upon sections 402(b) or 403(b) of the Code.

Perhaps, in the case of a small business in an unstable industry or a shoestring operator, making the segregation of a fund the pivotal point of the case is valid. In the case of a large and prosperous corporation, however, the mere promise to pay would seem to be as much of a benefit to the employee-taxpayer as a promise funded by deposits with an escrow agent, and it is the benefit to the employee which should govern and not the loss of control over the fund by the employer. The result may work a penalty upon executives of small companies while leaving the way clear for the executives of the larger companies to accomplish substantial tax savings.

In the case of the boxer, the Service ruled that he was taxable upon the total amount of his share of the proceeds in the year in which it was paid to the club. It reasoned that the boxer was not an employee or independent contractor of the club, but a partner or joint venturer, and would, therefore, acquire ownership of his share of the proceeds immediately. The contract between the boxer and the club merely shifted possession of the fund for the three-year period.

This ruling appears to be a definite boon to taxpayers desiring to spread large current earnings over a number of years. If it does not entirely clear the path, it at least points out the obstacles. If the status of the contracting parties is that of employer-employee, or client-independent contractor, the first important obstacle to avoid is the physical segregation of a fund in which the employee is given a specific interest. Next, in order to avoid the doctrine of constructive receipt, the contract must be binding and be executed prior to the time that the money would otherwise be available to the employee. In a situation analogous to that of the boxer, it may be necessary to execute something in the nature of a personal-service contract, providing clearly that the performer has no interest in the proceeds of the venture other than his salary from the employer.

Perhaps still unclear under this ruling is the *Casale* type situation in which the employer "funds" the obligation to the employee by the purchase of an annuity in which it retains all of the rights of ownership. Will this be considered by the Service as a segregation of assets, or merely a bookkeeping entry? Of course, other incidental issues may arise, *i.e.*, will the amount credited by the corporation to the employee's account be considered necessary to meet the reasonable needs of the business within the meaning of section 531 of the Code? Will the proceeds payable to the survivor be income in respect of a decedent under section 691? How will the proceeds be taxed to the secondary beneficiary in case they are payable in installments after the death of the employee? All such issues are outside the scope of this article, but, obviously, must be considered by the tax planner.

There has been little difficulty from the employer's standpoint in these unfunded deferred compensation situations. Under section 404(a)(5), as interpreted by the Regulations, section 1.404(a)-12, when and as payments are made to the employee, his rights are nonforfeitable and the employer may take a deduction at that time.[45] It is to be noted that since the payments are deductible under this

45. Rev. Rul. 60-31, *supra* note 44, expressly ruled upon this point.

section, if they also meet the requirements of section 162, an accrual-basis taxpayer is treated exactly as one using the cash and disbursements method of accounting.

IV. Conclusion

With the promulgation of Revenue Ruling 60-31, one of the dark corners in the area of deferred compensation was illuminated. Employers and employees may obtain commitments from the Service that proposed pension, profit-sharing, or stock-bonus plans will qualify for deferred treatment. Taxpayers, notwithstanding *Russell Manufacturing Co.*,[46] can be reasonably certain of the Service's position as to the tax consequences of nonqualified but funded programs. The recent ruling now outlines a method whereby highly paid executives may obtain substantial benefits not otherwise available to them.

The Service, in issuing Revenue Ruling 60-31, had to resolve a conflict of basic tax concepts. On the one hand, taxation of promises before payment would tend to obliterate the fundamental distinction between cash- and accrual-basis taxpayers; on the other, the failure to tax such promises would undermine to some extent the policy of progressive taxation and impair the usefulness of, and incentive for, qualified plans. It is the opinion of the writer that either resolution of this conflict would have been difficult to criticize. The resolution adopted, however, should weaken the Treasury Department's opposition to H.R. 10, the so-called Jenkins-Keogh bill, which proposes to extend the tax benefits of deferred compensation to self-employed persons.

46. 59 U.S. Tax Cas. ¶ 9582 (Ct. Cl. 1959).