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# VOLUNTARY PAYMENTS TO WIDOWS OF CORPORATE OFFICERS AND EMPLOYEES

FRANK J. PELISEK\*

The tax status of voluntary payments to widows of corporate officers and employees continues to be involved in considerable controversy.

In a previous article in this publication,<sup>1</sup> your author ventured the opinion that such payments would continue to be treated, for federal tax purposes, as gifts. Such has not been the case. The decision of the United States Supreme Court in *Commissioner v. Duberstein*<sup>2</sup> has caused the Tax Court to do a complete about-face in its attitude toward cases in this area and it has, since *Duberstein*, consistently held that such payments constitute taxable income in the hands of the widow. Other courts, including the United States District Court for the Eastern District of Wisconsin<sup>3</sup> have held to the position that such payments constitute non-taxable gifts. Before any discussion of this conflict can profitably be undertaken, it is necessary to glance at the decision of the Supreme Court in *Commissioner v. Duberstein* and *Stanton v. United States*,<sup>4</sup> a companion case.<sup>5</sup>

*Duberstein* involved the transfer of an automobile to the taxpayer by a business associate to whom the taxpayer had furnished leads to potential customers while *Stanton* involved a gratuity paid by a real estate corporation wholly owned by Trinity Church to a resigning officer of the corporation.

In the determination in both cases the Court specifically rejected the Treasury's invitation to adopt a standard test in rather general terms which it hoped could be made to apply in all subsequent gift cases. Such test was phrased in the following terms:

Gifts should be defined as transfers of property made for personal as distinguished from business reasons.<sup>6</sup>

Rather the Court indicated that the governing principles in the gift area were necessarily general and that such principles had already been fully spelled out in prior opinions. Further the Court noted that the whole problem of the tax treatment of gratuitous transfers was one which

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<sup>1</sup> Pelisek, *Tax Treatment of Payments to the Widows of Corporate Officers and Employees*, 44 MARQ. L. REV. 16 (1960).

<sup>2</sup> 363 U.S. 278 (1960).

<sup>3</sup> *Rice v. United States*, 197 F. Supp. 223 (E.D. Wis. 1961).

<sup>4</sup> 363 U.S. 278 (1960).

<sup>5</sup> Also decided on the same day was *United States v. Kaiser*, 363 U.S. 299 (1960), which determined that union payments to strikers at the Kohler plant were non-taxable gifts.

<sup>6</sup> *Supra* note 2, at 284.

“does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases.”<sup>7</sup> Thus the Court in initially rejecting the “broad brush” test proposed by the Government indicated that each gift was to stand upon its own facts and that such facts would be applied to a series of concepts established in several prior decisions.

Such concepts may be stated as follows:

(1) The presence of a gift within common-law concepts does not determine the presence or absence of a gift for tax purposes since the mere absence of a legal or moral obligation to make the transfer which is sufficient to create a common-law gift does not establish that such transfer is a gift for tax purposes.<sup>8</sup>

(2) If the payment proceeds primarily from the constraining force of any moral or legal duty or from the incentive of anticipated benefit of an economic nature such payment is not a gift.<sup>9</sup>

(3) Where the payment is in return for services rendered, it is irrelevant that the donor receives no economic benefit from the payment.<sup>10</sup>

(4) A gift, within the meaning of Section 102 of the Code, proceeds from a detached and disinterested generosity<sup>11</sup> out of affection, respect, admiration, charity or like impulses.<sup>12</sup>

(5) The most critical consideration is the intention of the donor which controls regardless of the voluntary nature of the payment.<sup>13</sup>

Intention, the Court noted, is not to be viewed in the same light as donative intent for common-law gift purposes since the donor's characterization of his acts is not determinative for tax purposes. Rather intent is to be determined by an inquiry into the basic reason for the transferor's conduct in fact—the dominant reason that explains his action in making the transfer.<sup>14</sup>

The majority applied the above principles to determine, in *Duberstein*, that the Tax Court was not clearly erroneous in its finding that the intent of the transfer of the automobile was recompense for past services or inducement for future services. *Stanton* was remanded despite a clear finding of fact as to the existence of a gift because of the very sparseness of such finding with the resultant possibility that the wrong legal standard had been applied. Several strong dissenting

<sup>7</sup> *Ibid.*

<sup>8</sup> *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730 (1929).

<sup>9</sup> *Bogardus v. Commissioner*, 302 U.S. 34, 41 (1937).

<sup>10</sup> *Robertson v. United States*, 343 U.S. 711, 714 (1952). As an example of this general concept the Court cited the inclusion in gross income of tips.

<sup>11</sup> *Commissioner v. Lo Bue*, 351 U.S. 243, 246 (1956).

<sup>12</sup> *Supra* note 10, at 714.

<sup>13</sup> *Supra* note 9, at 43.

<sup>14</sup> *Supra* note 2, at 286.

opinions were filed in *Stanton*<sup>15</sup> primarily on the basis that the District Court had already made a fully determinative finding of fact as to the existence of a gift. On remand the trial court elaborated its findings slightly but retained the basic determination that a gift had been intended.<sup>16</sup>

How does the *Duberstein* decision affect the widows' cases here under discussion? Your author submits that *Duberstein* was merely a recitation of the existing law in this area and as such should have no substantial impact upon the prior decisions relating to payments to widows. This is clearly the view which has been adopted in *Rice v. United States*<sup>17</sup> and similar District Court determinations<sup>18</sup> discussed, *infra*, but which has been totally rejected by the Tax Court.

In its pre-*Duberstein* determinations in this area, the Tax Court consistently noted that the question of whether or not a gift was present was one of intent as determined from the facts in the specific case. This rule has not been changed by *Duberstein*. Intent as shown by each particular set of facts is still controlling. What then has caused the Tax Court to suddenly turn on the widow in favor of the Commissioner? Little analysis is provided in any of the recent decisions to answer this question. However, a review of the recent decisions will perhaps provide an insight into the determinations of future cases in this area and a guide for tax planning.

The first decision of the Tax Court in this area after *Duberstein* came in *Estate of Mervin G. Pierpont*.<sup>19</sup> There payments were made to the widow pursuant to a corporate resolution indicating such payments were made "in recognition of the services rendered" by the deceased and "as a continuation of his salary." This was typical of the language used for many payments which had previously been held to result in tax-free gifts.<sup>20</sup> The Tax Court indicated, however, that prior authority could be disregarded in light of the *Duberstein* decision since there the Supreme Court

. . . went a long way towards bringing the problem back into proper focus, thereby clarifying and developing the law in this troublesome area.<sup>21</sup>

Although the Court designated the area as a troublesome one, it had found little previous difficulty in consistently determining payments

<sup>15</sup> *Supra* note 2, at 293.

<sup>16</sup> *Stanton v. United States*, 186 F. Supp. 393 (E.D. N.Y. 1960).

<sup>17</sup> *Supra* note 3.

<sup>18</sup> *United States v. Kasynski*, 284 F. 2d 143 (10th Cir. 1960); *Cowan v. United States*, 191 F. Supp. 703 (N.D. Ga. 1960); *Frankel v. United States*, 192 F. Supp. 776 (D. Minn. 1961).

<sup>19</sup> 35 T.C. 65 (1960).

<sup>20</sup> *Estate of Arthur W. Hellstrom*, 24 T.C. 916, 918 (1955).

<sup>21</sup> *Supra* note 19, at 68.

similar to the one present in *Pierpont* to be gifts. Apparently only the Commissioner found the area truly troublesome since he was a consistent loser both in the Tax Court and elsewhere.

In sustaining the Commissioner's determination that the payments, to the extent they exceeded \$5,000, were taxable income, the Court commented that the sole question was one of intent with the burden of proof placed upon the taxpayer to show that the payments were intended as gifts. Such intent must be shown by "solid evidence" and the "Court is not warranted in indulging in conjectures in petitioner's favor to fill the gap."<sup>22</sup> The solid evidence required which was found to be lacking apparently consisted of evidence that the payments were motivated by the needs of the widow or by a sense of generosity. Proof on the latter point would appear difficult indeed, but proof relating to the needs of the widow could be produced if in fact the widow were in need. Failure of any proof of this type has been noted in all of the Tax Court cases in this area subsequent to *Pierpont*. Judge Kern in a strong dissent in *Pierpont* advanced the theory which has been applied by the District Courts in urging that *Duberstein* involved radically different facts from those normally involved in widows' cases and that consequently it offered little aid. He further noted that if the test advanced by the Government in *Duberstein* had been accepted, the tax law in this area might have been affected, but, that since such test had been specifically rejected the prior case law was controlling.

*Estate of Martin Kuntz, Sr.*<sup>23</sup> followed soon after *Pierpont*.<sup>24</sup> There the resolution indicated that the payment of a year's salary of the deceased to his widow was "to the best interests, and benefit of the corporation" and was "made as additional compensation and in consideration of services heretofore rendered" to the corporation by the deceased. Under such circumstances the Court had little difficulty in finding the payments as compensation for past services and thus taxable to the widow. *Reed v. United States*,<sup>25</sup> a recent victory for the widow, was noted as clearly distinguishable on its facts and also to have been decided prior to *Duberstein*. The next Tax Court case of note in this general area was *Ivan Y. Nickerson*.<sup>26</sup> There monthly payments equal to the deceased officer's monthly base salary made to his surviving

<sup>22</sup> *Supra* note 19, at 69.

<sup>23</sup> 19 T.C.M. 1379 (1960).

<sup>24</sup> Decided immediately prior to *Kuntz* was *Abe A. Danish*, 19 T.C.M. 1349 (1960) where the Court found that payments made by an acquiring corporation to former employees of an acquired corporation were motivated by the "constraining force of a moral or legal duty" and thus under *Duberstein* were includible in gross income. The factual situation was similar to *Bogardus v. Commissioner*, *supra* note 9, where the Supreme Court had found such payments to be gifts.

<sup>25</sup> 177 F. Supp. 205 (W.D. Ky. 1959), *aff'd sub nom.* 277 F. 2d 456 (6th Cir. 1960).

<sup>26</sup> 19 T.C.M. 1508 (1960).

children were held to constitute dividends. The following discussion of the Court appears particularly instructive in regard to the required evidence of intent:

The resolutions are devoid of any language which even remotely suggests that the authorization of the payments proceeded from a detached and disinterested generosity or that a reason, basic, dominant or otherwise, for the authorization was affection, respect, admiration, charity or like impulses for either the decedent or his five children. In this connection it is observed that the three directors who 'unanimously' adopted the resolutions of April 3, 1954, were children of the decedent, that each received \$250 a month under the resolutions, and that the record does not contain any suggestion that any of the five children of the decedent was in need.<sup>27</sup>

Judge Raum was the next one of the Tax Court panel to face the issue. In both *Estate of Irving Cooper*,<sup>28</sup> and *Mildrew W. Smith*,<sup>29</sup> resolutions providing for payments in recognition of the services of the deceased were held to result in taxable income to the widow. *Smith* is of particular significance since there the record indicated some consideration had been given by the directors to the widow's diminished income as a result of her husband's death. However, the Court found that no consideration had been given to her income from other sources which in fact was substantial or to her capital resources. Thus from the record Judge Raum concluded the payments were not based upon need and thus gifts were rather additional compensation.

The need factor also dominates the remaining cases which have been decided to date by the Tax Court on this issue.<sup>30</sup> Other factors which have been noted include:

- (1) Payments did not name widow as recipient.<sup>31</sup>
- (2) Payments of like nature previously made by the corporation.<sup>32</sup>
- (3) Treatment of the payments by the corporation as salary.<sup>33</sup>
- (4) Substantial stock ownership by widow.<sup>34</sup>
- (5) Adoption of the resolution prior to the death of the officer involved.<sup>35</sup>

With the present attitude of the Tax Court toward payments of this type perhaps the presence of any one of the above facts would be

<sup>27</sup> *Id.* at 1513.

<sup>28</sup> 20 T.C.M. 774 (1961).

<sup>29</sup> 20 T.C.M. 775 (1961).

<sup>30</sup> *Estate of W. R. Olsen*, 20 T.C.M. 807 (1961); *Estate of Julius B. Cronheim*, 20 T.C.M. 1144 (1961); *Mary Fischer*, 20 T.C.M. 318 (1961); *Estate of Rose A. Russek*, 20 T.C.M. 123 (1961); *Mary C. Westphal*, 37 T.C. #36 (1961) and *Roy I. Martin*, 36 T.C. #56 (1961).

<sup>31</sup> *Estate of Julius B. Cronheim*, 20 T.C.M. 1144 (1961).

<sup>32</sup> *Ibid.*

<sup>33</sup> *Mary C. Westphal*, 37 T.C. #36 (1961).

<sup>34</sup> *Estate of Rose A. Russek*, 20 T.C.M. 123 (1961).

<sup>35</sup> *Mary Fisher*, 20 T.C.M. 318 (1961); *Estate of Rose A. Russek*, *supra* note 34.

sufficient to defeat gift status. Certainly this would be the case if, in addition, little or no consideration had been given to the needs of the widow which the Tax Court indicates is of critical significance.

A completely opposite approach to that exhibited by the Tax Court has been taken by the other Federal courts which have faced the issue. Indicative of this is the following statement of Judge Grubb in *Rice v. United States*:<sup>36</sup>

The recent decision of *Estate of Mervin G. Pierpont v. Commissioner of Internal Revenue*, 35 T.C. 65 (1960), and cases following its holding show a change in the tax court's interpretation of the term 'gift' as used in the Internal Revenue Code. It is the opinion of this court that Commissioner of Internal Revenue v. Duberstein, *supra*, relied on in the Pierpont case, reaffirms previous principles rather than proposes new rules governing the determination whether corporate transfers constituted gifts for the purposes of the Internal Revenue Code. Accordingly, where, as in the instant case, there has been a showing of donative intent and where an objective inquiry reveals the substance of the transaction as consistent with the transferor's intention, the payment in question qualifies as a gift.<sup>37</sup>

The facts in *Rice* indicated that the widow was not in financial need; that the payments were "in recognition" of the services of the deceased; that upon the previous death of another key employee like payments had been made; and, that the corporation treated the payments as salary allowances on its own tax returns. In commenting upon the facts the Court specifically rejected the need of the widow as a controlling factor by stating:

Further, a charitable impulse based on the widow's need may be one of several motivating factors in these cases. It does not follow that corporate gifts can be made only to the impecunious and needy.<sup>38</sup>

In addition Judge Grubb noted that a single previous payment of this nature did not constitute a plan or policy so as to bring the case within the doctrine of *Simpson v. United States*,<sup>39</sup> and that the facts that the payments were measured by the salary of the deceased and were treated as salary by the corporation were not controlling.

Evidence strongly relied upon by the Court to support the finding of a gift consisted of testimony by two of the corporation's directors, (one of whom was the son of the deceased), that the payments were prompted by a feeling of esteem for the deceased and grief at his death and undertaken as a token of sympathy and appreciation. This is clearly a lesser degree of proof that the "solid evidence" now required by the

<sup>36</sup> *Supra* note 3.

<sup>37</sup> *Supra* note 3, at 226.

<sup>38</sup> *Supra* note 3, at 227.

<sup>39</sup> 261 F. 2d 497 (7th Cir. 1958).

Tax Court and shows a much clearer appreciation for the practical problems of presentation of proof in the area of intent.

Undoubtedly under the determination in *Pierpont* and subsequent Tax Court decisions the payments to Mrs. Rice would have been classed as income if the case had been litigated in the Tax Court. The divergence in result rests solely on the difference in interpretation of *Duberstein*. The Tax Court appears to accept that decision as a mandate of the Supreme Court to abandon its long history of prior decisions in favor of the widow, while Judge Grubb, as indicated above, interprets *Duberstein* as a mere restatement of prior law including that body of tax law supporting the widow's position. Such has also been the approach of the other Federal courts but without the very helpful elaboration given by Judge Grubb.<sup>40</sup> It appears that only the determination on appeal of either the Tax Court decisions or those of the District Courts will remedy the existing split of authority. Several such appeals are pending at this time and a holding of aid in solving the problem may be forthcoming shortly. However, the split of authority on gift status is not the only problem in this area which is unsolved.

One further problem in this area involves the effect of Section 101(b)<sup>41</sup> of the 1954 Code which provides for a \$5,000 exclusion from gross income for employee death benefits. The Treasury contends, apparently on the strength of dicta in two District Court cases under the 1939 Code,<sup>42</sup> that all payments on account of the death of an employee including gratuitous payments to the employee's widow are governed by Section 101(b) and that consequently all amounts received in excess of \$5,000 are gross income. This position has met with a unanimous lack of success before the Courts which have had occasion to face it. In *Reed v. United States*,<sup>43</sup> the first reported case in which the issue was raised, the Court noted that Section 102(a) of the 1954 Code contains a specific provision that gross income does not include amounts received as gifts and that nothing contained in Section 101(b) alters the meaning of 102(a). Consequently, it determined that payments which it found to be gifts were not subject to the \$5,000 limitation. Other courts have unanimously followed.<sup>44</sup> The Tax Court, since it has consistently found the payments to be taxable, has not yet been required to pass on the question. Despite universal rejection the Commis-

<sup>40</sup> See cases cited *supra* note 18. See also *Wilner v. United States*, 195 F. Supp. 786 (S.D. N.Y. 1961) where the Court in denying cross-motions for summary judgment discussed the entire problem at some length.

<sup>41</sup> Int. Rev. Code of 1954 §101(b).

<sup>42</sup> *Bounds v. United States*, 262 F. 2d 876, 878 (4th Cir. 1959) and *Rodner v. United States*, 149 F. Supp. 233, 237 (S.D. N.Y. 1957).

<sup>43</sup> 177 F. Supp. 205 (W.D. Ky. 1959), *aff'd* 277 F. 2d 456 (6th Cir. 1960).

<sup>44</sup> *Cowan v. United States*, 191 F. Supp. 703, 705 (N.D. Ga. 1960); *Frankel v. United States*, 192 F. Supp. 776 (D. Minn. 1961); *Rice v. United States*, 197 F. Supp. 223 (E.D. Wis. 1961); *Wilner v. United States*, 195 F. Supp. 786 (S.D. N.Y. 1961).

sioner has not abandoned his position and has announced that the Service will not follow the decision in *Reed*.<sup>45</sup> The Service still tenaciously clings to the position that voluntary payments to the widow of a deceased employee constitute employee death benefits and are thus subject to the limitation of Section 101(b). Litigation over the question will thus continue at least for the present.

One of the recent Tax Court decisions contains an interesting ramification of the effect of Section 101(b).<sup>46</sup> There the widow received a cash payment of \$5,000 in addition to a lump sum distribution from the company profit-sharing plan. In her return she treated the direct cash payment as a gift and took the \$5,000 exclusion allowed by Section 101(b) against the profit-sharing distribution. The Court, although finding the cash distribution to constitute income, allowed the widow to apply the exclusion of Section 101(b) against such amount leaving the lump sum distribution from the plan wholly taxable but at the more favorable capital gain rates.<sup>47</sup>

A further problem in this area relates to the deductibility of the payment by the corporation. In the recent *Cooper*<sup>48</sup> case the Tax Court specifically held that the amounts paid to the widow, which it had found to constitute additional compensation, were deductible by the corporation. This determination was in accord with other recent authority.<sup>49</sup> However, in two other recent Tax Court decisions deductibility has been denied. In *Harry L. Davis Co.*<sup>50</sup> the company treated the payments on its books as salary earned by the widow. The Court denied the deduction because of a failure by the company to show any active participation by the widow in the running of its affairs. Payments in prior years which had been classified as gifts to the widow had previously been challenged by the Service but the controversy had been settled by the disallowance of a deduction for such payments for one of the three years involved. In subsequent years the taxpayer attempted to sustain the deduction on the basis of salary earned or in the alternative as a salary continuation for the widow. The Court determined that since the primary position of salary earned could not be sustained the taxpayer was not free to rely on the payments as salary continuation although it recognized that in proper cases a deduction would be allowed for such payments.

In *Barbourville Brick Company*<sup>51</sup> payments were made to a widow who owned either directly or in a fiduciary capacity 168 out of 180

<sup>45</sup> Rev. Rul. 60-236, 1960-2 Cum. Bul. 32.

<sup>46</sup> Estate of W. R. Olsen, 20 T.C.M. 807 (1961).

<sup>47</sup> Int. Rev. Code of 1954 §402(a) (2).

<sup>48</sup> Estate of Irving Cooper, 20 T.C.M. 774 (1961).

<sup>49</sup> See Fifth Avenue Coach Lines, Inc., 31 T.C. 1080 (1959) and Champion Spark Plug Company, 30 T.C. 295 (1958), *aff'd* 266 F. 2d 347 (6th Cir. 1959).

<sup>50</sup> T.C. Memo 1961-209.

<sup>51</sup> 37 T.C. #2 (1961).

shares of the company's outstanding stock. Under such circumstances the Court held the payments to constitute non-deductible dividends although the resolution was worded to indicate that the payments were to constitute a gratuity to the widow.

On the deductibility question note should be made of the fact that in *Rice*<sup>52</sup> the corporation had deducted the payments as "salary allowances" or "widow's allowance". The Court found this fact as not controlling. Such reasoning is in complete accord with *Duberstein* where the Court stated:

. . . it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the 'gift' exclusion; nor does it draw any distinction, in terms, between transfers by corporations and individuals, as to the availability of the 'gift' exclusion to the transferee. The conclusion whether a transfer amounts to a 'gift' is one that must be reached on consideration of all the factors.<sup>53</sup>

Many of the earlier decided cases sustaining gift treatment for the widow were similar to *Rice* in that they involved situations where a business deduction had already been allowed to the corporation either as salary or as a widow's allowance. Upon the subsequent finding of gift status of the payments in the hands of the widow, the Service had lost both ways. To avoid this problem the Service has now begun to disallow the deduction to the corporation and at the same time to treat the payments as income to the widow. This inconsistent treatment places the corporation and the widow at opposite ends of the question and forces them to, in effect, fight each other while the Service sits back and waits. Since the corporation is often at a higher bracket and consequently the disallowance of the deduction means more in tax dollars than the inclusion of the payment in the widow's income it normally will be the widow who will be forced to concede. To sustain her position she needs the complete support of the corporation management which authorized the payment, and if the corporation is forced to place its own deduction of the payments in jeopardy by such support, it will, in most instances, probably not be forthcoming. This tactic by the Service will undoubtedly reduce the amount of litigation in this area but it clearly will not completely halt the controversy as long as the widow has the friendly forum afforded by the District Courts available to her.<sup>54</sup>

<sup>52</sup> *Supra* note 3.

<sup>53</sup> *Supra* note 2, at 287.

<sup>54</sup> Of interest to Wisconsin practitioners is the present peculiar situation of widows' payments here. The Service insists that such payments be treated as income for federal tax purposes while the Wisconsin Department of Taxation insists that they be treated as gifts, for state purposes with the resultant im-

In summary it appears that the controversy over the treatment of gratuitous payments to widows of corporate officers and employees will continue until either the Supreme Court settles the issue or the Treasury seeks and obtains legislative action. At present the widow is meeting with a unanimous lack of success before the Tax Court. She must therefore pay her asserted deficiency and seek refund in the friendlier confines of the District Courts.

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position of gift tax at the maximum basic rate levied by Wis. STAT. §72.77(4) (1959) and non-deductibility to the corporation. See *Spangler v. Department of Taxation*, 255 Wis. 51, 37 N.W. 2d 857 (1949).