Federal Income Taxation: Deferred Compensation Agreements and the Doctrine of Constructive Receipt

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Federal Income Taxation: Deferred Compensation Agreements and the Doctrine of Constructive Receipt—Petitioner was a high salaried executive of Briggs Corporation. In October, 1952, petitioner and Briggs executed an employment contract which included a plan for deferred compensation to be paid to petitioner after his retirement or when he reached age sixty-five, whichever event occurred first. In December, 1953, Briggs sold the major portion of its manufacturing facilities to Chrysler Corporation, and petitioner, being no longer needed on a full time basis by Briggs, was employed in the same capacity by Chrysler. In complete satisfaction of its employment contract with petitioner, Briggs agreed to pay to a trustee $90,000, in installments of not less than $1,500 per month, in consideration for which petitioner agreed to be available on a part time basis in an advisory and consulting capacity and not to accept other employment inconsistent with that of Briggs. When petitioner retired from full time employment with Chrysler or when he reached age sixty-five, he was to receive from the trustee $1,500 per month until the trust funds were exhausted. Briggs was willing to pay petitioner directly but the plan involving payments to a trustee was suggested by petitioner.

Payments under this contract commenced in February, 1954 and each month thereafter during 1954 and 1955, Briggs paid $1,500 less withholding tax to the trustee, charging the payments to salary expense during those years. Petitioner, a cash basis taxpayer, did not include those payments in his gross income for 1954 or 1955, but did claim a tax credit for the amounts withheld by Briggs. The Commissioner determined that these payments were taxable to the petitioner in the years they were paid by Briggs to the trustee. Held: Judgment for the Commissioner; The attempted trust arrangement had no substantive effect. Because Briggs was willing to pay petitioner directly, he constructively received the income at the time it was paid into the trust. The trustee was simply acting as petitioner's designated agent to receive the payments for him. George W. Drysdale, 32 T.C. No. 37 (1959, now on appeal to the 6th Circuit Court of Appeals.

The doctrine of constructive receipt is not contained in the Code. However it has been present in the Treasury Regulations almost since the sixteenth amendment was passed. It was initially promulgated in Regulations forty-five, Article fifty-three under the Revenue Act of 1918 and remained unchanged in verbiage until the Regulations under

1 Treas. Reg. 62, art. 52 (1921)
Treas. Reg. 65, art. 51 (1924)
Treas. Reg. 69, art. 51 (1926)
Treas. Reg. 74, art. 332 (1928)
Treas. Reg. 77, art. 332 (1932)
Treas. Reg. 86, art. 42-2 (1934)
the Revenue Code of 1954 rearranged the form but left the substance intact. Generally, the two tests that must be met in order to establish a constructive receipt are (1) the income is credited to the taxpayer's account or otherwise set apart for him, and (2) the income must be free from any substantial limitations or restrictions as to the time, manner or conditions of payment.

Although the doctrine originated as an administrative interpretation, it has been applied by the courts in a long string of decisions. Probably the first case to apply it was John A. Brander, in which the president of a corporation who had accrued salary credited to him on the corporate books, but refused to withdraw it, was held to have constructively received the salary in the year in which it was credited to his account. Other early cases which follow in the classic mold established by the Regulations, are Corliss v. Bowers where taxpayer attempted to set up a trust for the benefit of his family and retained the power to revoke or alter the trust; and Loose v. United States where interest coupons that had matured before the holder's death but were cashed thereafter by his widow were determined to be income to the decedent during his life.

As early as 1934 the Internal Revenue Service was apparently trying to expand the scope of the doctrine. In Commissioner v. Tyler the court, emphasizing the "no substantial limitation" aspect of the rule, found that, contra to the Commissioner's position, income from the sale of stock placed in escrow and under the terms of the escrow agreement, not receivable by taxpayers until the following year, was taxable income to them in the year actually received by the taxpayers, and not in the year when the money was placed with the depositary.

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2 The present regulation on this subject, Treas. Reg. §1.451-2(a) on which the court in the Drysdale case relies is only slightly changed from Treas. Reg. 118 § 39.42-2 and others preceding it. See note 1 supra.
3 3 B.T.A. 231 (1925).
4 The court, even in this early case, while citing article 53 of Regulations 45, emphasizes the fact that constructive receipt is an artifice to be applied sparingly lest it become a means for taxing something other than income and thus violating the constitution itself.
5 Treas. Reg. §1.451-2(b) gives the more common examples of income constructively received: bond interest coupons which have matured, stock dividends unqualifiedly made available to the stockholder, and interest credited on savings bank deposits.
6 281 U.S. 376 (1930) in which Justice Holmes stated the basis for applying the doctrine, "The income which is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income whether he sees fit to enjoy it or not."
7 74 F. 2d 147 (8th Cir. 1934).
8 72 F. 2d 950 (3d Cir. 1934).
Since 1934 there have been several similar cases. They fell generally into two classes, deferral of payment for personal services, and deferral of payment of the proceeds from a sale of personalty.

An example of the first category is Clifton B. Russell. In 1941 petitioner Russell was voted a bonus of $50,000 "payable when the treasurer of the Corporation in his sole discretion may determine." The Treasurer paid petitioner $25,000 in 1941 and placed the remainder in trust for him in 1942. The tax court held that the portion placed in trust was neither actually nor constructively received in 1941, again the decisive factor being non-availability of the bonus.

In J. D. Amend the petitioner was a wheat farmer who habitually sold for delivery and payment in the year succeeding that in which the contract was signed. The Commissioner contended that because the petitioner could have sold his wheat for cash that he constructively received the proceeds in the year of sale. The court found for the petitioner, that since the sales contracts were bonafide arms-length transactions and petitioner had no control over the proceeds, he could not be taxed for them until the year of actual receipt.

Estate of Richards v. Commissioner involved a fact situation closely paralleling that in the Drysdale case. There the taxpayer had obtained

9 5 T.C. 974 (1945).
10 A similar fact situation existed in George W. Johnson, 25 T.C. 499 (1955) where petitioners, all officers and stockholders in their company, received salary checks and mutually agreed not to cash them until the company president advised them to do so. It was held the checks were not taxable until such permission was received from the president. In this case and some others, notably Charles K. Thurston, 22 B.T.A. 1062 (1931) the fact that there were insufficient funds in the company treasury to pay the accrued salaries was at least partially responsible for a decision of no constructive receipt.
11 13 T.C. 178 (1949).
12 It is on this basis that the court distinguishes the Drysdale case from James F. Oates, 18 T.C. 570 aff'd 207 F. 2d 711 (7th Cir. 1953) which holds that employer and employee may amend their original employment contract so as to have the income spread over a longer period of time than provided for by the original contract. Quoting from Drysdale: "The Oates case involved ... a mutually advantageous bonafide agreement reached through arms-length bargaining. ... It should be noted that the agreement had a legitimate business purpose aside from the fact that it enabled the agents to defer their reporting of income.
"In the instant case however, the only apparent purpose for Briggs making the payments to the trustee ... was to reduce petitioner's tax burden."

That a business purpose on the part of the company in Oates was a moving factor in the decision is not apparent to the writer. It appears that the decision there is based almost solely on the fact that petitioners had no rights to the other income at all until they actually received it, at which time they included it in gross income.
13 That the government now regards this case as good law is implied in a 1958 ruling:

"The proceeds from the sale of wheat by a farmer using the cash receipts and disbursements method of accounting under a bonafide arm's-length contract calling for payment in the taxable year following that in which the wheat was delivered to the purchaser, are includable in his gross income for the taxable year in which payment is received."
14 150 F. 2d 837 (2d Cir. 1945).
a lower court judgment of $381,000. While appeals were pending, two defendants offered to settle for $100,000 apiece. The taxpayer accepted one offer in December, 1936 but refused as to the other in order to reduce his taxes in 1936. In January, 1937, taxpayer accepted the other defendant's offer. The commissioner attempted to have the settlements both taxed in 1936. In holding contra to the commissioner, the court determined that nothing was credited or set apart for the taxpayer which he could draw on in 1936 so that the applicable regulation's requirements clearly were not complied with. It is interesting to note that the factor so much relied on by the tax court in the Drysdale case, that the taxpayer could have had the money immediately had he so desired, was not considered controlling in the Richards case.10

In 1955 there occurred what appears to be the first major gravitation by the courts away from the strict fact situation previously required for the application of the doctrine. In Williams v. United States17 the taxpayer sold some timber to a purchaser who, at the seller's request, placed the purchase price in escrow with an agreement that the bank holding the money could only pay one-fifth of the amount to the seller in each of five consecutive years following the year in which the contract was made. In a remarkable about-face from the Tyler18 and Richards19 decisions, the court determined that as a matter of law, petitioner had constructively received the purchase price in the year of sale because the purchaser had been willing to pay him directly. So far as this writer can determine, there was no warning for this sharp break from the traditionally understood constructive receipt situation, where control of the income by the taxpayer was essential for application.20 Since the Williams case there have been at least two other instances21 of courts approving this extension.

In the Drysdale situation the court might have found an easier way out simply by applying section 402(b) of the Code since the payments were made to a trust.22 But the actual decision raises the question of

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17 219 F. 2d 523 (5th Cir. 1955).
18 See note 8, supra.
19 See note 14, supra. Although both these cases and several others in point were cited by petitioner, all were passed over by Chief Judge Hutcheson in his opinion and no attempt was made to distinguish them.
20 Earlier, another method had been employed to skirt the element of availability. The "cash equivalent" doctrine, as exemplified in E. T. Sproull, 16 T.C. 244 (1951) aff'd 194 F. 2d 541 (6th Cir. 1951) may be applied where money was paid out by the company into a trust and was irretrievable by the company but still not presently accessible to the employee. The theory behind this doctrine is that although the employee has no access to the money presently, there still has been an economic benefit conferred on him to the extent of the amount deposited.
21 In the Drysdale case and in Frank Cowden, 32 T.C. No. 73 (1959).
22 The omission of mention of this section in the briefs was questioned by the
whether all courts will now consistently recognize the extension made in the constructive receipt doctrine or are Drysdale and Williams to be considered isolated fact situations with the doctrine still generally to be confined to the traditional circumstances? If the Drysdale case is generally accepted, what danger does it offer to the traditional deferred compensation plan? A somewhat typical example of this sort of plan is the original contract of employment in the Drysdale case. It provided, in addition to current compensation, that on Drysdale's retirement or when he reached age sixty-five, whichever event occurred sooner, he would be paid not less than $1,500 monthly for the next ten years and in the event of his death during that time, the payments were to be made to either his administrator or some party designated in his will. In return for this Drysdale was to be available in an advisory and consulting capacity, so long as he remained alive and mentally and physically able, and was not to accept employment inconsistent with that of Briggs. In order to distinguish this original contract from the one condemned in the case, two factual differences should be noted between them. In the original contract, although the record does not show who suggested the deferred payments, no provision was made for the use of a trust. In the contract as amended, the payments were to be made currently to the trustee and Briggs deducted them as salary expense. Also under the first plan the company continued to pay Drysdale a regular salary for his present services so that it could not readily be determined just how much of the deferred amount was compensation for these services and how much was for the services to be performed after retirement. After Briggs sold out to Chrysler, Drysdale was paid nothing directly for current services performed for Briggs so that the commissioner could and did determine that the entire amount paid to the trustee was really remuneration for services performed concurrently. With the aid of oral testimony to that effect from an officer of Briggs, the court upheld this determination. The amended contract and any comparable agreement involving a non-forfeitable interest in a trust would not effectively defer taxation of the employer's contributions. But because of the aforementioned factors

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23 A vice-president of the company, on the trial of the matter, testified that Briggs would have been willing to pay the cash to Drysdale directly, but at the latter's suggestion the trust was set up.

24 If not because barred by the constructive receipt doctrine, then under the sections of the code pertaining to non-qualified trusts (Int. Rev. Code of 1954, § 402(b) and to non-exempt annuities (§ 403(c)). But a plan of funding through insurance that is not irrevocable is not necessarily fatal. In Casale v. Commissioner, 247 F. 2d 440 (2d Cir. 1957) taxpayer held 98% of the stock of a corporation that made annual payments on an insurance policy
the original contract, had it remained in existence, would have had a
good chance of succeeding as intended. It appears that any individual
defered compensation plan that is not specially funded could not be
taxed to the employee until such time as he actually received the pay-
ments and the company would be able to deduct the payments at that
time as well.25

If the reasoning in the Drysdale case is followed literally and the
willingness of the employer to pay the employee currently and directly
for services rendered currently is generally accepted as a criterion for
constructive receipt, then the commissioner will be in a position to
contend that many non-qualified26 deferred compensation plans are not
effective tax-wise. But where the employee is receiving a current salary
for regular services performed, it would be a practical impossibility
for the government to determine and prove what portion of the de-
ferred benefits the employer would have been willing to pay the em-
ployee directly, had the employee so requested it. Presumably the em-
ployer would state that any subsequent payments are contingent on the
employee’s complying with the requirements of the contract after his
retirement.

However, even if the doctrine of constructive receipt is not a fatal
obstacle to the use of the traditional deferred compensation plan, the
attorney must bear in mind that there are other methods of taxing
defered payments currently.27 He can be fairly certain though, that
courts which have for thirty years and more preached a sparse applica-
tion of the doctrine of constructive receipt are not likely to consent to
such a wholesale expansion of that doctrine.

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