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Section 102(a)[1] excludes from gross income property acquired by "gift, bequest, devise, or inheritance." The oft-quoted standard for determining whether an uncompensated transfer qualifies as a gift is set forth in the Supreme Court's 1960 decision in *Commissioner v. Duberstein*, as a transfer preceding from "detached and disinterested generosity" and not in return for past or future services.[2] The crucial factor in applying the *Duberstein* standard is the intention that the *transferor* had in making the transfer;[3] however, there are situations in which that standard should be modified by taking into account the circumstances of the *transferee*.

In the Tax Reform Act of 1986, Congress added subsection (c) to section 102 to replace the subjective *Duberstein* standard with a more objective rule in one specific situation.[4] Section 102(c) provides that the exclusion from income of section 102(a) cannot apply to a transfer from an employer to, or for the benefit of, an employee.[5] The focus of this Article is to examine the following questions: (1) whether, despite its unrestricted language, section 102(c) does not apply to some gratuitous transfers to an employee; (2) if so, what are the exceptions to section 102(c); and (3) when section 102(c) does not apply to a transfer, whether it will be excluded from income.

If section 102(c) does not apply to an *inter vivos* transfer to an employee, the transfer must then satisfy the *Duberstein* standard to qualify as a gift. Part II of this Article examines the conditions under which a gratuitous transfer to an employee will be excluded from income under the *Duberstein* standard and under the normal tax treatment of testamentary transfers—in other words, how the section 102(a) gift and bequest exclusion from income is applied when section 102(c) is inapplicable. Part III examines the operation of section 102(c).

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[1] Unless otherwise indicated, any citation in this Article to a section number is to a section of the Internal Revenue Code of 1986.

[2] 363 U.S. 278 (1960); *see also* Bogardus v. Commissioner, 302 U.S. 34, 43, 45 (1937).

[3] *Duberstein*, 363 U.S. at 285.

[4] I.R.C. § 102.

[5] I.R.C. § 102(c).

Before examining the application of the *Duberstein* standard to employee gifts, it is useful to put that standard in context by considering a policy justification for excluding gifts from the donee's income. The determination of whether a specific transfer qualifies as a gift for tax purposes should consider whether treating the transfer as a gift would be consistent with the policy reasons for allowing an exclusion. Professor Jeffrey Kahn and I examined that issue in a 2003 article and proposed a principled rationale for the exclusion.[6] The brief discussion of this issue in Part I is drawn from that article, and the position of the Author on that issue and response to contrary views are set forth more thoroughly in that earlier article.

I. Policy Justification for Exclusion of Gifts

A number of commentators maintain that there is not a valid policy justification for excluding gifts, which therefore should be made taxable to the donee.[7] To the contrary, the Author contends that there is a valid justification for the exclusion. Ironically, the justification is grounded on principles encapsulated in the well-known Haig–Simons definition of income—popularized by Henry Simons in the book where he first described that definition.[8] It is ironic because it is in that same book that Simons advocated that gifts should be included in income.

Simons defined income as the

> sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to "wealth" at the end of the period and then subtracting "wealth" at the beginning.[9]

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[6]Douglas A. Kahn & Jeffrey H. Kahn, *"Gifts, Gafts and Gefts"—The Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income*, 78 NOTRE DAME L. REV. 441 (2003); *see also* Richard Schmalbeck, *Gifts and the Income Tax—An Enduring Puzzle*, 73 LAW & CONTEMP. PROBS. 63 (2010).

[7]*E.g.*, HENRY C. SIMONS, PERSONAL INCOME TAXATION 56–58 (1938); Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); William Klein, *An Enigma in the Federal Income Tax: The Meaning of the Word "Gift,"* 48 MINN. L. REV. 215 (1963); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 28–37 (1992); Lawrence Zelenak, Commentary, *The Reasons for a Consumption Tax and the Income Taxation of Gifts*, 51 TAX L. REV. 601, 602–03 (1996).

[8]SIMONS, *supra* note 7, at 50. Many provisions of the tax law do not conform to the Haig–Simons definition of income. The Haig–Simons definition is sometimes described as an ideal to which the tax law can aspire. The characterization of that definition as an "ideal" is not universally accepted. Even if one accepts that characterization, there can be competing policies that warrant departing from it. The tax law is a pragmatic enterprise that does not operate in isolation of societal and economic events and needs.

[9]*Id.* at 50.

The term "consumption" in the formula refers to personal consumption, as contrasted to consumption connected with the conduct of a business or the production of income. As used in this Article, any reference to "consumption" is to personal consumption. Adopting the definition expounded by Professor Warren, consumption generally refers to the "ultimate use or destruction of economic resources."[10] Warren defines "economic resources" as the "goods and services that are generally the subject of market transactions," expressly excluding psychic benefits.[11] In general, a person consumes an item or service when it is removed from the societal store of goods and services, and is either used up or dedicated to the exclusive use of that person.[12]

Income tax then is a tax on the taxpayer's current consumption during a taxable year plus the amount of wealth the taxpayer accumulated in that year. The wealth that was accumulated in a taxable year can be seen as representing the present value of the future consumption that will be purchased with that wealth. It is assumed that the accumulated wealth will be used for consumption at some future date either by the taxpayer or by someone else who subsequently acquires it. While the proper current taxation of future consumption might seem to require a discount of the value of the future consumption to reflect the time gap before it occurs, any discount should be offset by the income that the taxpayer can earn from the investment of the accumulated wealth prior to its use for consumption; therefore, it is proper to tax the entire amount of the accumulated wealth without applying a discount. The amount of discount to be applied to future consumption is based on the rate of return that the accumulated wealth can produce; consequently, the total amount of discount will equal the total income that the accumulated wealth can produce. The income earned from the investment of the accumulated wealth will give rise to additional future consumption, so it is reasonable to offset the

[10] Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1084 (1980).

[11] *Id.*

[12] In certain circumstances, a person's use of a resource will be treated as a consumption even though his use is not preclusive and does not destroy the resource. For example, a person's use of a software program does not prevent others from using that same program. Why then should a payment of a fee to obtain the right to use the program for personal, nonbusiness purposes be treated as a consumption? It is treated the same as a consumption for tax purposes in that the payment is not deductible even though it reduces the taxpayer's wealth, and so the taxpayer effectively is taxed on that payment as if it were a personal consumption. Perhaps the answer is that even though that use does not fit the consumption model, it would contravene another tax policy to allow a deduction for a personal expenditure, and so no deduction is allowed. As observed above, the tax law does sometimes depart from the Haig–Simons model to accommodate other policy objectives. *See supra* note 8 and accompanying text.

discount by the income-producing capacity of the accumulated wealth.[13]

Thus, the income tax can be seen as a tax on current and future consumption. The reason that consumption has been considered to be the lynchpin of the income tax is described in the aforementioned 2003 co-authored article.[14] At least one commentator rejects the contention that the income tax on accumulated wealth is a tax on future consumption and instead maintains that it is a tax on the "power to affect consumption."[15] Even so, it seems incontrovertible that the taxation of income is inexorably tied to consumption so that once an income tax has been paid on accumulated income, a second income tax should not be imposed when that accumulated income is used to consume an item or service.

How then does the relationship of the income tax to consumption affect the question of whether a gift should be excluded from income? The taxation of future consumption is based on the expectation that the accumulated wealth will be used for consumption at some time in the future, and it does not matter whether it will then be consumed by the taxpayer or by someone else.[16] This suggests that the taxpayer should be permitted, without incurring any additional income tax, either to consume his accumulated wealth himself or to allow someone else to consume it. The taxpayer should be given the widest latitude to obtain the maximum utility from the consumption of his accumulated wealth. If a taxpayer can obtain greater utility by vicariously enjoying consumption—or his anticipation of the consumption—by someone of the taxpayer's choosing, then the taxpayer should be allowed to have his previously taxed wealth so employed.

The reason that a gift is excluded from the donee's income has nothing to do with the merits—or lack thereof—of the donee; rather, it is to allow the donor to obtain the maximum utility for the consumption of the income on which he has been taxed.[17] If a gift were subjected to income tax, the consumption that could be obtained from the previously taxed income would be reduced, which would conflict with the principle of allowing the after-taxed income to be consumed in full.

There is an alternative to excluding gifts from income that would also comply with the principle of taxing a single consumption only once: The donee could be taxed on the gift, and the donor could be allowed a deduction for

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[13]Of course, the income from the accumulated wealth is subjected to income tax when earned. Because the prospective income to be earned from the accumulated wealth has been taken into account by the tax law in justifying the failure to discount the future consumption that will be purchased with that wealth, the income effectively was taxed in the year that the wealth itself was accumulated. Taxing the income again when earned is a kind of double taxation of the same item. This double taxation of the income from investments creates a bias against savings in favor of current consumption. The existence of that bias is a factor in why some persons prefer a consumption tax to the income tax system.

[14]Kahn & Kahn, *supra* note 6, at 454–55.

[15]Kornhauser, *supra* note 7, at 32.

[16]Kahn & Kahn, *supra* note 6, at 454.

[17]*Id.* at Part I.C.3.

making it. There is a compelling reason not to take that approach: it would undermine progressivity. A high-bracket taxpayer could shift the incidence of the income tax to a lower bracket taxpayer by making a gift to the lower bracket taxpayer. The anticipatory assignment of income doctrine is designed to prevent taxpayers from shifting the incidence of the income tax to lower tax bracket persons.[18] Permitting a deduction for a donor would contravene that policy.

Of course, a gift or bequest may be subjected to a gift or estate tax in some circumstances, and that imposition will reduce the amount that is available for consumption. Obviously, the imposition of transfer taxes conflicts with the policy of excluding gifts from income. Transfer taxes are independent of the income tax and serve different purposes. The point made above is that the income tax should not interfere with the full use of the after-taxed income for consumption purposes when the accumulated wealth is transferred to someone else. Other taxes or costs that may arise are subject to separate considerations. It is a matter of Congress's balancing of competing policies. Congress deemed the policies underlying transfer taxes to be superior to the policy permitting a taxpayer the privilege of having another consume his taxed income, so the transfer tax system took priority.[19]

The donor of a gift typically does derive benefits therefrom. The donor can derive pleasure from the satisfaction of seeing the excitement and joy that the donee displays upon receiving or using the gift. The donor may acquire some moral suasion that provides him with influence over subsequent choices that the donee will make.[20] These psychic pleasures are not a financial benefit. To the extent that a transfer provides the transferor with a financial benefit, it will not be a gift for tax purposes. The psychic pleasures that a donor acquires from making a gift do not involve the consumption of any item or service because no societal good or service has been used up. The property transferred by the donor is not consumed until it is either exhausted or dedicated to a person's exclusive use. If the mere transfer of the property is not a consumption, as the Author has concluded, then the donor should be allowed the vicarious enjoyment of having the property consumed by the donee.

It would be an error to equate enjoyment with consumption. While the two often go together, neither is a requisite for the other. One can consume an item without deriving any enjoyment from it. For example, X could purchase shoes believing that they will serve a useful function. Upon wearing them, X discovers that they are extremely painful, and so discards them.

His disappointment and failure to obtain enjoyment from the purchase do not prevent it from constituting a consumption. Conversely, X can obtain great enjoyment from events that do not constitute a consumption of any

[18] *Id.* at Part I.C.7.

[19] *Id.* at Part I.C.4.

[20] As King Lear learned to his detriment, the donor is not necessarily able to influence the donee after the gift is made.

goods or services. For example, X can enjoy the warmth of the sunshine or the beauty of a full moon without consuming anything. X can enjoy the company of a friend or child without consuming anything. Consumption requires the destruction or preclusive use of property or services. The consumer presumably expects to get enjoyment from a purchase, but its consumption does not depend upon whether he actually does.

Commentators who contend that gifts should be income to the donee have not asserted that the donor should recognize a gain or loss.[21] If the enjoyment that the donor obtains is treated as consideration for the transfer, the transaction would then appear to be an exchange that would be taxable to the donor as well as to the donee. The value of the consideration received by the donor could be deemed to be equal to the value of the property the donor transferred, on the assumption that an arm's-length exchange constitutes an exchange of equal values.[22] While it is doubtful that many would approve that treatment, it would seem to follow from the underlying premise of treating a gift as income to the donee. For example, if an employer transferred property in kind to an employee as payment for services, the employer would recognize gain or loss in the amount of appreciation or depreciation of the transferred property. The services the employer received in exchange would be deemed to be equal in value to the transferred property.

The inappropriateness of treating a donor as recognizing a gain on making a gift adds strength to the congressional decision to exclude gifts from a donee's income. The difference between a gratuitous transfer of property and a payment for a service is striking. If X uses after-tax income to pay Z for painting X's home, X will have consumed Z's service, and so X will have obtained the consumption that his prior payment of the income tax entitled him to. Z will be taxed on the receipt of that payment, and so Z is entitled to use that payment to consume an item or service. There will be two impositions of the income tax, but there will be two consumptions of goods or services. In contrast, when X makes a gift of property to M, there will be no consumption of goods or services until M uses it. Between X and M together, there will be only one consumption, and so only one income tax should be imposed.

While the principle of maximizing the taxpayer's options for consumption supports the exclusion of gifts from income, there is a conflicting principle pointing toward taxing gifts. Under the Haig–Simons definition of income, the accretion to an individual's wealth should be treated as income regardless of the source of that income. Commentators who contend that gifts should be income to the donee rely on the Haig–Simons principle.[23] Because two significant principles are in direct conflict with each other, a choice must be made as to which will be given priority. Congress has consistently chosen to

[21] Kahn & Kahn, *supra* note 6, at n.5.
[22] *See* United States v. Davis, 370 U.S. 65, 72 (1962).
[23] SIMONS, *supra* note 7, at 56–57, 128.

prioritize the principle of allowing the donor a wide scope for the consumption of taxed wealth, and has exempted gifts from income.[24] In the Author's view, Congress made the correct choice because taxing gifts would be inconsistent with the current system of taxing accumulated wealth as a surrogate for taxing future consumption—even though the future consumption may be enjoyed by someone other than the taxpayer. In any event, it cannot be said that Congress's choice of one principle over the other is a departure from an ideal tax system; the two principles in question are mutually exclusive and one of them has to give way.

Some commentators who oppose the exclusion of gifts make an exception for gifts to certain family members such as a spouse or children.[25] This exception is grounded on a view that the taxpayer and a close relative can be regarded as a single unit for some, but not all, tax purposes. The single unit concept should not be restricted to family members. If a taxpayer cares enough about someone to permit that person to consume some of the taxpayer's wealth, that circumstance is sufficient to cause the taxpayer and the other person to be treated as a single unit for some limited tax purposes.[26] The *Duberstein* standard of resorting to the transferor's intention to determine whether the transferor made the transfer out of detached and disinterested generosity conforms to the congressional decision to permit the taxpayer to choose whose consumption would provide the taxpayer with the most utility.[27] All that the donor achieved by making the gift was to permit the donee to consume the donated property.

In applying the *Duberstein* standard, courts have indicated that the transferor's intention is the exclusive test.[28] While that usually is correct, there are situations where other considerations should be taken into account. Under normal circumstances, the congressional choice of elevating the principle of allowing a taxpayer an expansive range of consumption options over the principle of taxing accretions to wealth is reasonable. But there are circumstances where the principle of taxing accretion to wealth takes on greater weight and should be given priority. While no court has expressly adopted that distinc-

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[24]Gifts were excluded from income in the revenue act of 1913 (the first revenue act enacted after the adoption of the Sixteenth Amendment to the Constitution) and have continued to be excluded ever since. *See* Kahn & Kahn, *supra* note 6, at 442 n.2.

[25]*E.g.*, Dodge, *supra* note 7, at 1203.

[26]This view of gifts is buttressed by the manner in which a donee's basis in donated property is determined. When a gift is made of property in kind, the donee takes the same basis in the donated property that the donor had at the time of the gift, albeit the donee's basis is modified in certain circumstances. I.R.C. § 1015(a). The rationale for that rule is that the donor's basis represents the two parties' single investment in the property. *See* Taft v. Bowers, 278 U.S. 470, 482 (1929). The effect of this basis rule is to treat the donor and the donee as a single unit for certain specified tax purposes. For a more extensive discussion of the single tax unit concept see Kahn & Kahn, *supra* note 6, at 469–74.

[27]Commissioner v. Duberstein, 363 U.S. 278, 285 (1960).

[28]*See, e.g.*, Demetree v. Commissioner, 94 T.C.M. (CCH) 126, 2007 T.C.M. (RIA) ¶ 2007-210.

tion to modify the *Duberstein* standard, there are cases where it seems likely that that was the actual motivation for the court's decision.

One such case is the U.S. Court of Appeals for the Ninth Circuit's decision in *Olk v. United States*.[29] The taxpayer in *Olk* was a craps dealer in several Las Vegas casinos. The patrons of the casinos used "tokes" (*i.e.*, chips) to make their bets. A small percentage of patrons would give a portion of their winnings to the dealer. No custom existed that would pressure a patron to make those "gifts," and most did not do so. Under the rules of the casinos, the tokes that a dealer received were required to be combined with tokes received by other dealers and then divided equally.[30] The taxpayer had a steady amount of receipts from this practice, averaging about $30 a day. The question in litigation was whether the taxpayer's receipt of these tokes constituted income or gifts. The district court made a number of findings; one was that the patrons gave the tokes to the dealer out of detached and disinterested generosity.[31] The district court held that the tokes were gifts that are excluded from income.[32]

While the Ninth Circuit properly reversed that decision, its stated rationale was flawed. The court held that the district court's determination of "detached and disinterested generosity" was a conclusion of law to which the "clearly erroneous" standard of review did not apply.[33] The Ninth Circuit's decision was significantly influenced by the fact that the receipt of the tokes was regarded by the dealers as a regular part of their compensation.[34] The court said,

> [m]oreover, in applying the statute to the findings of fact, we are not permitted to ignore those findings which strongly suggest that tokes in the hands of the ultimate recipients are viewed as a receipt indistinguishable, except for erroneously anticipated tax differences, from wages. The regularity of the flow, the equal division of the receipts, and the daily amount received indicated that a dealer acting reasonably would come to regard such receipts as a form of compensation for his services. The manner in which a dealer may regard tokes is, of course, not the touchstone for determining whether the receipt is excludable from gross income. It is, however, a reasonable and relevant inference well-grounded in the findings of facts.[35]

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[29] 536 F.2d 876 (9th Cir. 1976), *cert. denied*, 429 U.S. 920 (1976); *see also* Komjathy v. Adm'r of the Fed. Aviation Auth., 486 U.S. 1057 (1988); Tomburello v. Commissioner, 86 T.C. 540 (1986), *aff'd without published opinion*, 838 F.2d 474 (9th Cir. 1993), *cert. denied*, 486 U.S. 1057 (1988); Catalono v. Commissioner, 81 T.C. 8 (1983), *aff'd without published opinion sub. nom.* Kroll v. Commissioner, 735 F.2d 1370 (9th Cir. 1984) (holding that chips received by casino employees from patrons of the casinos were income to the recipient).

[30] *Olk*, 536 F.2d at 877.

[31] *Id.*

[32] *Id.* at 876.

[33] *Id.* at 878.

[34] *Id.* at 879.

[35] *Id.*

While the Ninth Circuit reached the correct result in *Olk*, it might better have grounded its decision on the basis that when a transferee receives gratuitous transfers from strangers as a regular and anticipated element of his livelihood, the principle of taxing accretions to wealth takes on greater weight and should be given priority.[36] The question of whether those circumstances warrant departing from the standard's exclusive reliance on the transferor's intention did not arise in *Duberstein*, and so should not be deemed to be foreclosed by the decision in that case.

Consider the following illustration. John, who lost his legs some years ago, is a professional beggar. He occupies a space on a busy street and collects a substantial amount of donations which constitute his livelihood. John makes no false representations of his condition. The donations he receives are freely given by strangers out of detached and disinterested generosity. Should those donations be excluded from John's income, or should the fact that he is a professional donee require that he be taxed on them? In the view of the Author, John should be taxed. Note, however, that an application of an unmodified *Duberstein* standard would treat those donations as gifts and exclude them from income.

II. Application of Section 102(a) to Gratuitous Transfers Made to an Employee

A transfer to an employee for which no property is received in return is typically made to the employee as either compensation for past services, an advance payment for services to be performed in the future, or a combination of both. Another possible purpose is to encourage the continued employment of the recipient of that transfer and of other employees, including prospective employees, who might be induced by that transfer to believe that faithful service would, at some future date, net them comparable treatment. Transfers for any of these reasons would not qualify for an exclusion from income because they are designed to provide an economic benefit to the transferor and so are not made out of "detached and disinterested generosity."

On the other hand, it is possible for an employer to have genuine affection for an employee with whom the employer has had significant contact. In some cases, the employee might actually be a member of the employer's family such as a child or a spouse. A gift to an actual family member should not be recast as compensation merely because the relative happens to be employed by the transferor. In the more common situation where the employee is not actually

[36]The *Olk* case is discussed in greater depth in Kahn & Kahn, *supra* note 6, at 476–82. A different treatment of regular transfers to an individual is warranted when the parties are related or have a relationship in which persons customarily make gifts. So, for example, if an adult child were to live off of an allowance provided by his parent, the allowance should be excluded from income as a gift. This is one of the circumstances in which the tax treatment of a transfer can be influenced by the relationship of the transferor to the transferee. As we shall see, another circumstance in which the parties' relationship is a relevant factor is when an employer transfers property to an employee.

related to the employer, their relationship might grow to the point where the employer regards the employee as an informal member of his family. In such cases, just as can be the case when the employee is an actual relative, a transfer to the employee might be made out of affection rather than as compensation. While such friendships arise more frequently in cases of household employment, they can also occur when an employee, who is employed by a small business, works closely with the owner.

This Part examines how the exclusion provision of section 102(a) applies to lifetime and testamentary transfers to an employee without regard to the application of section 102(c). Part III examines the application of section 102(c). The question of how a testamentary transfer to an employee should be treated invokes different considerations than those that apply to *inter vivos* transfers, and so the two situations are examined separately.

A. Inter Vivos *Transfers to an Employee*

In the *Duberstein* case, the government proposed a standard for determining what constitutes a gift that would have ruled out gift treatment for most transfers from employers to employees.[37] As reported by the Court, the government contended that voluntary payments to an employee ought to be "by and large" taxable.[38] As so stated, it seems that even the government acknowledged that there are circumstances where a transfer to an employee might be a gift. In any event, the Court rejected the government's position and expressly refused to adopt a bright-line standard for determining what constitutes a gift. Instead, the Court held that the intention of the transferor in making the transfer is the crucial determinant.[39] The voluntariness of a transfer is not sufficient to make it a gift. To be a gift, the transfer must proceed out of the transferor's detached and disinterested generosity. The transfer should be made out of "respect, admiration, charity or like impulses."[40] If the transferor's incentive was to obtain an economic benefit, the transfer would not be a gift.

The *Duberstein* standard is typically stated as requiring "detached and disinterested generosity" for the transfer to qualify as a gift, and that phrase is frequently used in this Article. However, the reader should keep in mind that the phrase itself is not that helpful in resolving gift issues. To apply the *Duberstein* standard, it is necessary to understand what types of transfer purposes are embraced within the phrase "detached and disinterested generosity," and how those purposes interact with the facts of each situation. The Eighth Circuit expressed its doubts as to the usefulness of that phrase as follows:

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[37] The standard proposed by the government was that "[g]ifts should be defined as transfers of property for personal as distinguished from business reasons." Commissioner v. Duberstein, 363 U.S. 278, 284 n.6 (1960).

[38] *Id.* at 287.

[39] *Id.* at 285–86 (quoting Bogardus v. Commissioner, 302 U.S. 34, 43 (1937)).

[40] *Id.* at 285 (quoting Robertson v. United States, 343 U.S. 711, 713–14 (1952)).

> Many courts nevertheless give talismanic weight to a phrase used more casually in the *Duberstein* opinion—that a transfer to be a gift must be the product of "detached and disinterested generosity." . . . [I]t is the rare donor who is completely "detached and disinterested." To decide close cases using this phrase requires careful analysis of what detached and disinterested means in different contexts. Thus, the phrase is more sound bite than talisman.[41]

In *Duberstein*, the Court noted that if a transfer was made in return for services rendered, it would not be a gift even if the transferor derived no economic benefit from making the transfer.[42] Thus, tips given to a service provider are income to the recipient.[43] The line between compensating an employee for past services, and making a gift in gratitude for the loyal and faithful service that an employee had provided, rests on making a difficult, subtle, and fine distinction. That difficulty was eliminated by the 1986 addition of section 102(c); the legislative history establishes that an employer's appreciation of an employee's service does not establish the type of relationship that prevents the application of that provision.[44] There is reason to question whether, as a matter of policy, a transfer proceeding from gratitude for an employee's service should be taxed differently than compensation for past service, and section 102(c) treats them the same.

The Court held that the test of "detached and disinterested generosity" is a factual question so that each case must be resolved on the basis of the facts presented.[45] While the Court recognized that transfers made in a business context usually will not be gifts, the Court also recognized that human relationships are complex and diverse, and that there are circumstances where such transfers will be made primarily out of detached and disinterested generosity.[46] The Court's decision in *Duberstein* involved two separate cases that were consolidated for the Court's review. It is instructive to see how the Court dealt with each of those cases.

In *Duberstein*, the taxpayer, who was president of one corporation, had had business dealings with the president of an unrelated corporation.[47] From time to time, the taxpayer had voluntarily given the other president names of clients for the other company to solicit, and the taxpayer had neither sought nor expected compensation for doing so. In appreciation of what the tax-

[41] Goodwin v. United States, 67 F.3d 149, 152 n.3 (8th Cir. 1995).

[42] 363 U.S. at 285 (quoting Robertson v. United States, 343 U.S. 711, 714 (1952)).

[43] Reg. § 1.61-2(a)(1). Indeed, the Supreme Court expressly stated that tips are income in footnote seven of the *Duberstein* decision. 363 U.S. at 285 n.7. The Tax Court has approved a formula for estimating the amount of an employee's tip income, sometimes referred to as the "McQuatters Formula." *See* McQuatters v. Commissioner, 32 T.C.M. (CCH) 1122, 1973 T.C.M. (RIA) ¶ 73,240.

[44] See the quote from the House Report to the 1986 Act in the text accompanying note 85, *infra*.

[45] *Duberstein*, 363 U.S. at 285, 288–90.

[46] *Id.* at 287.

[47] *Id.* at 280.

payer had done, the other corporation "gave" the taxpayer an automobile. The Tax Court upheld the Commissioner's determination that the receipt of the automobile was income to the taxpayer.[48] The Court of Appeals for the Sixth Circuit reversed and treated the receipt as a gift.[49] The Supreme Court reversed the Sixth Circuit and held that the factual determination of the Tax Court was conclusive because it could not be said to be clearly erroneous.[50]

In *Stanton*, the other case consolidated before the Court in *Duberstein*, an officer of a corporation received a gratuity from his employer upon his retirement.[51] The district court, sitting without a jury, found that the payment of the gratuity was a gift.[52] The district court did not make any findings as to the facts on which it based its conclusion. The Court of Appeals for the Second Circuit reversed.[53] The Supreme Court reversed the Second Circuit, but sent the case back to the district court for more explicit findings.[54] It is noteworthy that the Court left open the possibility that the payment of the gratuity would be treated as a gift, even though it was made by an entity to an employee. It is also noteworthy that on remand, the district court again held that the taxpayer's receipt of the gratuity was a gift, and the Second Circuit affirmed that decision.[55]

In the majority of circumstances, an uncompensated transfer of property to an unrelated employee will be income to the latter.[56] Notwithstanding the gift treatment applied in *Stanton*, even if the payment is made to a retired employee, and even when made prior to the adoption of section 102(c), the payment was often included in income.[57] While the transferee is no longer employed when the payment is made, the payment could be for past services performed when the transferee was an employee. While there are only a few authorities subsequent to *Duberstein* that dealt with retirement payments,[58]

[48] *Id.* at 281.

[49] *Id.*

[50] *Id.* at 291–92.

[51] *Id.* at 281–82.

[52] *Id.* at 278, 283.

[53] *Id.*

[54] *Id.* at 278, 293.

[55] Stanton v. United States, 186 F. Supp. 393 (E.D.N.Y. 1960), *aff'd*, 287 F.2d 876, 877 (2d Cir. 1961).

[56] *Duberstein*, 363 U.S. at 287.

[57] *See infra* note 59.

[58] Since 1986, the issue typically will be resolved by applying section 102(c), and so the question of whether the payment would have qualified under the *Duberstein* standard will arise infrequently. *But see* Goodwin v. United States, 67 F.3d 149 (8th Cir. 1995) (a post-1986 case involving transfers to an employee that was decided on the *Duberstein* standard rather than section 102(c)).

the weight of those authorities favors taxing them.[59] However, there are circumstances where the *Duberstein* standard is satisfied.

Under what conditions will a payment to an employee qualify as a gift under the *Duberstein* standard? In the view of the Author, to conclude that a transfer proceeded from detached and disinterested generosity, all of the following five conditions have to be satisfied in order to negate an inference of compensatory purpose:

(1) The employer obtained no economic benefit from making the transfer.

(2) There was a personal relationship between the employer and employee of such nature that it would not be unusual for a gift to be made—that is, their relationship is one in which a transfer of property might well be made out of detached and disinterested generosity. While it might be possible for an entity to have such a relationship with an employee through the entity's chief officer or principal owner, it is more likely that a relationship of such a nature will occur between two individuals.[60] As noted in Part III, it will not be possible to avoid the application of section 102(c) to a transfer from an entity to its employee.

(3) The occasion for making the transfer was either an event where gifts are customarily made, such as a birthday, a marriage, an anniversary, or a graduation, or the employee had a financial need that would arouse the sympathy or concern of the employer.

(4) The actual compensation paid to the employee was reasonable when compared with compensation paid to persons who perform comparable work for others or for the employer.

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[59] *See, e.g.*, Nattrass v. Commissioner, 33 T.C.M. (CCH) 1389, T.C.M. (P-H) ¶ 74,300 (1974); Rev. Rul. 1976-516, 1976-2 C.B. 24; Rev. Rul. 1972-342, 1972-2 C.B. 36 (taxing payments to a retired employee); *see also* Estate of Sweeney v. Commissioner, 39 T.C.M. (CCH) 201, T.C.M. (P-H) ¶ 79,201 (1979).

On the other hand, *Brimm v. Commissioner*, 27 T.C.M. (CCH) 1148, T.C.M. (P-H) ¶ 68,231 (1968), treated a voluntary payment from an employer as a gift when a school that had ceased operations made payments to all of its professors. The payments were made pursuant to a "severance policy" that the school's trustees adopted. While the result in *Brimm* is questionable, the court was likely influenced by the fact that, because the employer terminated its business, the purpose of the payment could not have been to provide an inducement for the employee, or any other employee, to continue working for that employer. However, *Nattrass* also involved a payment from an employer that had terminated its business, and the Tax Court held that the payment was income to the employee. 33 T.C.M. (CCH) at 1389, T.C.M. (P-H) ¶ 74,300 (1968).

[60] However, there are pre-section 102(c) cases in which transfers from an entity to an employee were held to be gifts. One such case is the district court and court of appeals decision in *Stanton*, 287 F.2d 876 (E.D.N.Y. 1960), on remand from the Supreme Court. *Stanton* is one of the two consolidated cases that comprised the *Duberstein* decision in the Supreme Court. In *Estate of Carter v. Commissioner*, 453 F.2d 61 (2d Cir. 1971), the Second Circuit held that a corporation's payment to the widow of a deceased employee was a gift. Another case in which an entity's transfer to an employee was held to be a gift is *Brimm*, 27 T.C.M. (CCH) 1148, T.C.M. (P-H) ¶ 68,231 (1968).

(5) The payment was not pursuant to a contract, past practice, or an understanding that was designed to induce the employee to provide services. This requirement is not violated merely because an employer who has the required relationship with the employee had informed the employee that he will make a gift on an appropriate date such as Christmas, a birthday, or an anniversary; nor is it violated by a practice of making gifts on those or similar dates. It is only when the purpose of informing the employee or of having a practice of making gifts is to encourage the employee to continue in the employer's service that the requirement is violated.[61] This is a subjective test.

Part III considers whether there are any exceptions to the blanket rule of section 102(c) and, if there is an exception, to what extent its requirements differ from the five conditions listed above.

A more difficult question arises when an employee dies and the employer makes a payment to the employee's widow or other family member. The payment is not made to or on behalf of a current employee, but it is made with respect to a prior employee. Part III will consider whether section 102(c) applies to such payments. If there was a preexisting agreement, understanding, or plan that a payment would be made on the employee's death, the payment would be income to the recipient.[62] In such circumstances, the payment that was made after the employee's death would appear to be deferred compensation. But how should death benefits be treated when there was no preexisting plan, practice, or agreement?

Prior to the *Duberstein* decision, death benefits often were excluded from income as gifts.[63] After *Duberstein* was decided, the Tax Court generally held death benefits to be income unless unusual circumstances indicated that the payments were motivated by compassion.[64] Several of those Tax Court decisions were reversed.[65] District courts applying the *Duberstein* standard, however, were more open to finding that death benefit payments qualified as gifts if not made pursuant to a plan (formal or informal) or a preexisting policy.[66]

In many cases, a death benefit will be made pursuant to an agreement or

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[61] *Cf.* Roberts v. Commissioner, 69 T.C.M. (CCH) 2409, 1995 T.C.M. (RIA) ¶ 95,171.

[62] *See* Meyer v. United States, 244 F. Supp. 103 (S.D. Cal. 1965); Landry v. United States, 227 F. Supp. 631 (E.D. La. 1964); McCarthy v. United States, 232 F. Supp. 605 (D. Mass. 1964); Estate of Hellstrom v. Commissioner, 24 T.C. 916, 920 (1955). If the recipient of the payment has a significant ownership interest in the employer entity, the payment likely will be treated as income. *See* Dickson v. Commissioner, 23 T.C.M. (CCH) 1161, T.C.M. (P-H) ¶ 64,191 (1964).

[63] Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶ 10.2.4 (3d ed. 1999).

[64] Estate of Carter v. Commissioner, 453 F.2d 61, 66–67 (2d Cir. 1971); Bittker & Lokken, *supra* note 63.

[65] *See, e.g.*, Estate of Kuntz v. Commissioner, 300 F.2d 849 (6th Cir. 1962), *cert. denied*, 371 U.S. 903 (1962); Estate of Olsen v. Commissioner, 302 F.2d 671 (8th Cir. 1962), *cert. denied*, 371 U.S. 903 (1962).

[66] *See, e.g.*, Waters v. Commissioner, 48 F.3d 838, 850 (1995).

pattern of practice. As noted above, in those cases, the benefit usually was held to be taxable.[67] However, if there was no prior practice or agreement, and if the surviving family is destitute or has financial needs that elicit sympathy, the death benefit should qualify as a gift under the *Duberstein* standard even when the employer is an entity.[68] In addition, if there was a personal relationship between the employer and the deceased employee, the death benefit might be found as a fact to be motivated by affection or compassion.

In sum, a voluntary payment to an employee, or to the family of a deceased employee, can qualify as a gift if there is a finding that the *Duberstein* standard was satisfied and if the facts negate the inference that the payment was compensatory.

B. *Testamentary Transfers to an Employee*

If an employer dies and leaves a bequest to an employee, and if there was no prior agreement that the employer would make that bequest if services were performed by the beneficiary, the bequest will qualify for exclusion from income under section 102(a).[69] In such circumstances, the bequest obviously will not serve to induce the beneficiary to remain in the decedent's employ, and so that aspect of *inter vivos* gifts does not apply to testamentary transfers. However, a bequest might be made in satisfaction of a promise that was given to the employee to induce the latter to provide services during the decedent's life; such a bequest should be considered compensation for past services. If services were provided to the decedent in reliance on the decedent's promise to bequeath property to the service provider, the bequest is compensation to the beneficiary and should be included in the latter's income.[70] While the cases that have dealt with this issue involved enforceable agreements, a bequest made pursuant to an unenforceable understanding also should be included in income if the decedent's purpose in entering that agreement was to induce the employee to perform services.

The characterization for federal income tax purposes of the receipt of property under a valid settlement of a will contest is a federal question.[71] The

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[67] *See id.*

[68] *Estate of Carter* held that a corporation's payment to the widow of a deceased employee was a gift. 453 F.2d at 66–67.

[69] McDonald v. Commissioner, 2 T.C. 840 (1943); Jones v. Commissioner, 23 T.C.M. (CCH) 235, T.C.M. (P-H) ¶ 64,039 (1964); *see also* Estate of Tebb v. Commissioner, 27 T.C. 671 (1957), *acq.* 1957-2 C.B. 7. The beneficiaries in *Tebb* were children of the decedent, and there was an agreement that they would continue to work for the family's corporation. The court found that the decedent had expressed the wish to bequeath the property to them regardless. *Tebb*, 27 T.C. at 677. The decision for the taxpayer is questionable.

[70] Wolder v. Commissioner, 58 T.C. 974 (1972), *aff'd*, 493 F.2d 608 (2d Cir. 1974), *cert. denied*, 419 U.S. 828 (1974); Braddock v. United States, 434 F.2d 631 (9th Cir. 1970); Miller v. Commissioner, 53 T.C.M. (CCH) 962, T.C.M. (P-H) ¶ 87,271 (1987); Rev. Rul. 1967-375, 1967-2 C.B. 60. *But see* Roberts v. Commissioner, 69 T.C.M. (CCH) 2409, 1995 T.C.M. (RIA) ¶ 95,171.

[71] Lyeth v. Hoey, 305 U.S. 188, 193 (1938).

characterization depends upon the nature of the claim and the settlement.[72] The crucial question is, what was the settlement amount paid in lieu of? If there is a valid claim for inheritance, such as a claim based on the contention that a will was made under undue influence, the receipt of the property will be treated as a bequest that is excluded from income.[73] This rule is necessary to prevent tax consequences from deterring settlements of will disputes. If the plaintiff's claim is based on an agreement with the decedent to bequeath property if services were provided or if the claim is for quantum meruit, then the property should be taxable.[74] Notwithstanding how such claims should be treated, the courts and the Service have sometimes excluded such settlements from income.

One case that demonstrates the difficulty of predicting the outcome of litigating that issue is the Tax Court's 1995 memorandum decision in *Roberts v. Commissioner*.[75] In the *Roberts* case, Mildred agreed to leave her job and home in Ohio, and come to live with Elmer in North Carolina. Elmer was very ill, and Mildred cared for him for over eight years until he died. Elmer promised Mildred that he would leave her specified amounts and properties. Mildred loved and trusted Elmer. While she and Elmer discussed marriage, they never married. Mildred was treated by Elmer and his sisters as a member of their family. While Elmer's final will bequeathed property to Mildred, it was considerably less than he had promised her. Mildred filed a claim against the estate on the alternative grounds of breach of contract or for services rendered. The claim was settled for $50,000, and the settlement agreement stated that the settlement amount was one of the benefits conferred upon Mildred by the will. The Tax Court held that since the settlement agreement characterized the settlement as an amount due under Elmer's will, the amount Mildred received constituted a bequest for federal income tax purposes and was not taxable.[76] The holding in that case seems to be incorrect, but the taxpayer did present a sympathetic figure. A number of cases and rulings in this area are irreconcilable.[77] Part III considers whether the adoption of section 102(c) clarifies the treatment of gifts and bequests to an employee, former

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[72] *Id.*

[73] *Id.*

[74] *See* Green v. Commissioner, 54 T.C.M. (CCH) 764, T.C.M. (P-H) ¶ 87,503 (1987), *aff'd*, 846 F.2d 870 (2d Cir. 1988), *cert. denied*, 488 U.S. 850 (1988).

[75] 69 T.C.M. (CCH) 2409, 1995 T.C.M. (RIA) ¶ 95,171. For a similarly liberal exclusion of a settlement based on a contractual agreement for services of the taxpayer's spouse, see P.L.R. 2001-37-031 (Sept. 14, 2001). The taxpayer's spouse had ceased to be employed for some time before the claim was made, so there is a question whether section 102(c) was applicable, but the Service did not even consider whether section 102(c) applied. See also *Estate of Tebb v. Commissioner*, 27 T.C. 671 (1957), *acq.* 1957-2 C.B. 7, where a bequest was excluded from income even though there was a prior agreement for the receipt of services.

[76] Roberts v. Commissioner, 69 T.C.M. (CCH) 2409, 1995 T.C.M. (RIA) ¶ 95,171.

[77] *Compare id.*, *and* Estate of Tebb v. Commissioner, 27 T.C. 671 (1957), *acq.* 1957-2 C.B. 7, *with* Green v. Commissioner, 54 T.C.M. (CCH) 764, T.C.M. (P-H) ¶ 87,503 (1987), *aff'd*, 846 F.2d 870 (2d Cir. 1988), *cert. denied*, 488 U.S. 850 (1988).

employee, or relative of a former employee.

While, for a bequest to be excluded, there should be a requirement that the employer and the employee had a personal relationship, that relationship is virtually certain to have existed when an employer bequeaths property to an employee without there being an agreement for him to do so. Consequently, that requirement will not likely be an issue in testamentary cases. The most common circumstance in which a bequest is made to an employee is where the beneficiary was a household employee who had worked for the decedent for many years. Even though a household employee might have an expectation of receiving a bequest in that circumstance, the employee's expectation is no different than the expectation a child of the decedent might have. A household employee who has developed a personal relationship with his employer after serving the employer for a number of years may have become an unofficial member of the employer's family. While that family-type relationship can arise in other long-term employment relationships, they likely occur more frequently in connection with household employment.

III. The Application of Section 102(c)

As previously noted, subsection (c) was added to section 102 in 1986. Section 102(c) provides that section 102(a) "shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee."[78] The legislative history for this provision is sparse but does provide some guidance.

The provision was added to the Code by section 122(b) of the Tax Reform Act of 1986 (Act).[79] The title to section 122 of the Act is "Prizes and Awards." Employees can receive awards from their employer for accomplishments such as length of service or excellent conduct of their work.[80] In discussing the adoption of the section 102(c) provision, the House Report, the Senate Report, and the Conference Report to the Act all focus on employee awards and state that the addition of that provision means that it will no longer be possible to exclude such awards as gifts.[81]

Congress did not want the *Duberstein* standard to be applied to employee awards and chose a bright-line rule that prevented exclusion as a gift. Congress did note that an employee award might be excludable under some other statutory provision, such as a *de minimis* fringe benefit under section 132(e), or as an award under section 74(b) that the employee turned over to a qualified charitable organization.[82]

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[78] I.R.C. § 102(c).

[79] Tax Reform Act of 1986, Pub. L. No. 99-514, § 122(b), 100 Stat. 2085, 2110.

[80] *Id.* § 122(d), 100 Stat. at 2111.

[81] H.R. Rep. No. 99-426, at 103–06 (1985); S. Rep. No. 99-13, at 47–51 (1986); H.R. Rep. No. 99-841, pt. II, at 17–19 (1986) (Conf. Rep.).

[82] *See* sources cited *supra* note 81.

While employee awards were the focus of the Act, the scope of section 102(c) is not limited to awards. Let us now consider the application of that provision—first to *inter vivos* transfers and then to testamentary transfers.

A. Inter Vivos *Transfers to an Employee*

In adopting section 102(c), Congress intended to prevent gift treatment for employee awards regardless of whether the *Duberstein* standard could be met.[83] If such an award is to be excluded, it will have to fit under some other statutory provision. But what about transfers to an employee that do not constitute awards? The unrestricted language of the statute denies gift treatment to any transfer from an employer to, or for the benefit of, an employee.[84] It is reasonably clear, however, that notwithstanding that language, Congress did not intend to prevent gift treatment for all such transfers. The House Report on the 1986 Act states,

> [o]f course, gifts between individuals made exclusively for personal reasons (such as birthday presents) that are wholly unrelated to an employment relationship are not includible in the recipient's gross income merely because the gift-giver is the employer of the recipient. A transfer between personal acquaintances will not be considered to have been made exclusively for personal reasons if reflecting any employment-related reason (*e.g.*, gratitude for services rendered) or any anticipation of business benefit.[85]

In addition to this statement in the House Report, a proposed regulation was promulgated on January 9, 1989, adopting a similar construction of section 102(c). The proposed regulation states,

> [f]or purposes of section 102(c), extraordinary transfers to the natural objects of an employer's bounty will not be considered transfers to, or for the benefit of, an employee if the employee can show that the transfer was not made in recognition of the employee's employment. Accordingly, section 102(c) shall not apply to amounts transferred between related parties (*e.g.*, father and son) if the purpose of the transfer can be substantially attributed to the familiar relationship of the parties and not to the circumstances of their employment.[86]

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[83] *See* sources cited *supra* note 81.

[84] I.R.C. § 102(c).

[85] H.R. Rep. No. 99-426, at 106 n.5 (1985).

[86] Prop. Reg. § 1.102-1(f)(2), 54 Fed. Reg. 627 (1979). While it has been more than 30 years since the proposed regulation was adopted, and it has not yet been finalized, it is a sensible construction of the statute and generally conforms to the House Report on that provision. For a possibly contrary view see *Williams v. Commissioner*, 2005-1 U.S.T.C. ¶ 50,163, 95 A.F.T.R.2d 764 (10th Cir. 2005). *Williams* could have been resolved on the basis that the payment was made by a corporation (*i.e.*, an entity) to its employee, but the court discussed the issue as if the payment had been made by a shareholder of the corporation. The opinion in *Williams* is somewhat confusing, and it is understandable that it was not selected for publication in the Federal Reporter. The case is discussed *infra* note 97.

While Proposed Regulation section 1.102-1(f)(2) is more restrictive than the House Report, both pronouncements construe section 102(c) as not preventing gift treatment for some transfers to an employee. The gist of the proposed regulation and the quoted footnote from the House Report is that an individual can occupy more than one relationship with another person. An employee can have both a business relationship and a personal relationship with an individual who is his employer. If an individual makes a transfer to an employee, there must be a determination as to whether the transfer was made to the transferee in his capacity as an employee, or as a personal friend or relative. Section 102(c) applies only if the transfer was made to the transferee in his capacity of being an employee.[87] Even if section 102(c) does not apply, however, the transfer will still not be treated as a gift unless the transfer satisfies the *Duberstein* standard.

The same five requirements for applying the *Duberstein* standard to transfers from an employer to an employee that the Author proposed in Part II of this Article should also be conditions that must be satisfied to prevent section 102(c) from applying. While this might suggest that section 102(c) did not change much from the *Duberstein* standard, that is not true. It is more difficult to escape from section 102(c) than to satisfy the *Duberstein* standard. The statute covers employee awards, whereas previously they were sometimes treated as gifts. It is more difficult to demonstrate that an employer's transfer to an employee had no connection with the employment relationship than to establish that the principal purpose of a transfer was personal. The *Duberstein* standard rests on the transferor's principal purpose. As discussed below, principal purpose likely is not adequate to escape section 102(c)—a more stringent requirement applies. Also, as discussed below, a transfer from an entity to an employee cannot qualify as a gift under section 102(c).

The statement in the House Report precludes section 102(c) treatment if the transfer between individuals was made *exclusively* for personal reasons, and suggests two limitations on the exclusion from the statutory provision.[88] One is that the statute will apply to prevent gift treatment if the transferor is an entity, since the exclusionary language of the House Report is restricted to transfers between individuals. The Author will address that issue later. The second is that the transfer must be made exclusively for personal reasons. One might question whether that latter requirement is too restrictive. Consider the following illustration:

> G has been employed for 20 years in F's household to provide domestic services. In addition to her salary, G has occupied a room in F's home and has come to be regarded as part of the family. G is stricken with an illness that requires several years of expensive medical treatment. G's insurance will not pay for the treatment, and G lacks the funds to pay for it. F volunteers to pay for G's treatments. F's reason for doing so is his compassion for

[87] *See* H.R. REP. No. 99-426 (1985).
[88] *Id.*

> G's plight and his family's affection for her. However, F is also aware that the payment will induce G to remain in F's employment, and F regards that inducement as an additional benefit from making the contribution. F would have paid G's medical expenses even if G's medical condition would have prevented her from continuing to work. The fact that F had a minor compensatory purpose that did not influence F's decision to pay the medical expenses should not taint those payments.

Indeed, there likely will be a nonpersonal benefit of some nature in virtually every transfer to an employee, and so a requirement of exclusivity would make the exception to section 102(c) meaningless. A requirement of exclusivity is overly restrictive and should not be adopted.

Instead of an exclusive requirement, a primary purpose standard could be adopted, but that is too liberal. An objection to a primary purpose standard is that it impairs one of the objectives of section 102(c) to minimize the need to make difficult subjective determinations in order to ascertain whether the gift exclusion is applicable. Rather than requiring a weighing of several different purposes against each other, a more restrictive and administratively convenient requirement could be imposed. Instead of a primary purpose test, a taxpayer should be required to show that a personal purpose was both necessary and sufficient for the transfer to take place—that is, that the transfer would not have been made but for personal reasons, and that the transfer would have been made even if there had been no nonpersonal reasons for it. While that test also requires making judgments about the transferor's subjective motivation for making the transfer, a more restrictive standard should result in fewer cases where that issue would be close enough to be put into dispute. Moreover, a necessary and sufficient standard would preclude section 102(c) only when a nonpersonal benefit to the transferor had no effect on the decision to make the transfer. That latter aspect of a necessary and sufficient requirement is better attuned to the peremptory language of the statute.

Another question is whether an employer that is an entity can make a gift to an employee. As noted above, the statement from the House Report suggests that it cannot.[89] That seems an appropriate conclusion because the concept of a personal, nonbusiness relationship does not apply to the relationship between an entity and an individual.

While it appears an entity cannot make a gift to an individual employee, is it possible to reconstruct a transfer of property from an entity to an employee as a gift from an individual owner of the entity? For example, could a transfer to an employee from a closely held corporation or partnership be treated as a transfer from an individual shareholder or a partner? That approach would be an application of the substance versus form doctrine. If the facts indicate that the gift actually comes from an individual owner who has a personal reason to make the gift, it might seem that gift treatment should not be denied just because the assets of the entity were employed. However, that treatment of

[89] *Id.*

the transaction creates tax consequences that can significantly complicate the situation and so perhaps should be applied sparingly if at all. If the transfer of an entity's assets are deemed to have been made by an owner of the entity, then there should be a constructive distribution of the transferred assets to the owner, followed by a gift by the owner to the employee. The constructive distribution to the owner creates tax consequences and can raise difficult issues to resolve.

Let us first assume that the entity is a corporation with a sole individual shareholder who has a personal reason to make a gift to the employee. A constructive distribution of the transferred amount to the shareholder will cause the shareholder to have dividend income to the extent that the corporation has earnings and profits.[90] The constructive transfer of the property from the shareholder to the employee will be treated as a gift.[91] Even though that treatment does not cause undue complications, it should not be adopted unless the same approach will be applied when the corporation has multiple shareholders. If the constructive distribution approach causes too much complexity when there are multiple owners of the entity to apply the approach in those cases, then it would be better not to apply a constructive distribution approach even when there is a sole shareholder. It would be difficult for the Service or the courts to fashion a rule that would apply constructive distributions only when there is a single owner unless that rule were adopted by Congress as a statutory provision.

Now, let us assume that the corporate entity has three equal shareholders: A, B, and C. C has a personal reason to make a gift to the employee, but A and B do not. If the corporation's transfer of property to the employee is to be treated as a constructive distribution to the shareholders, which shareholders will be deemed to have received that constructive distribution? If each of the shareholders is deemed to have received one-third of the property transferred to the employee, and then transferred his share to the employee, the problem is that only C has a personal relationship with the employee that will qualify his constructive transfer as a gift. The constructive transfers by A and B would be deemed to have been made "for" the entity and would not qualify for gift treatment. If so construed, that would possibly require A and B to recognize dividend income, and the employee would still be taxed on two-thirds of the transfer he received. Rather than adopting such a complex and tax-costly construction, it would seem better to just treat one-third of the transferred property as having come from C, and the remaining two-thirds as having come from the entity. The employee would then be taxed on two-thirds of the property he received, but only C would have constructive dividend income.

Another possibility is to construe the transaction as a constructive distribution of 100% of the transferred property to C, followed by a gift from C to the employee. All of the dividend treatment would then fall on C, and the

[90] I.R.C. §§ 301(c)(1), 316(a). The corporation will not recognize income. I.R.C. § 311(a).
[91] *See* H.R. Rep. No. 99-426 (1985).

employee would have no income. The problem is that A and B have a right to share in the corporation's distributions, and their failure to exercise that right could cause each of them to have a constructive dividend of one-third of the amount transferred, followed by a constructive transfer from them to C.[92] Even though A and B are subject to taxation from their waiver of a dividend distribution, it is possible that the Service would not seek to impose dividend treatment on them; however they would be vulnerable to that treatment.

If the entity that makes the transfer is a partnership, a constructive distribution to the partners usually will not cause them to recognize income.[93] A partner will recognize a gain from receiving a distribution from the partnership only to the extent that cash and marketable securities that the partner received exceed the partner's basis in his partnership interest.[94] However, a distribution will reduce both a partner's basis in his partnership interest[95] and his capital account.[96] As with corporations, when there are multiple partners there is an issue as to how the constructive distributions should be allocated among them.

Currently, there is no authority treating an entity's transfer to an employee as a constructive distribution to the owners of the entity, followed by a gift of that constructive distribution to the employee. Given the complications such treatment can cause, it might be better not to apply that approach. Instead, the constructive distribution approach should be restricted to transactions where there is clear evidence that one or more of the owners of the entity are the true donors of the property.[97]

Proposed Regulation section 1.102-1(f)(2) states that *extraordinary* transfers to the natural objects of an employer's bounty will not be subject to section 102(c).[98] While the second sentence of the regulation refers to transfers between related parties, that is just an example of persons who could be the natural object of the transferor's bounty.[99] The exception is not limited to

[92] Rev. Proc. 1967-14, 1967-1 C.B. 591.

[93] I.R.C. § 731(a)(1). The partnership will not recognize income. I.R.C. § 731(b).

[94] I.R.C. § 731(a)(1).

[95] I.R.C. § 732.

[96] Reg. § 1.704-1(b)(2)(iv)(b).

[97] See *Williams v. Commissioner*, 2005-1 U.S.T.C. ¶ 50,163, 95 A.F.T.R.2d 764 (10th Cir. 2005), where payments from a corporation to an employee were included in the employee's income. The employee had a close, personal relationship with the president of the corporation—who also was one of its two shareholders. Ignoring the entity aspect of the payment, the court discussed the issue as if the payment had been made by the shareholder and as if the shareholder were the employer. The court did not consider what the ramification would be of having a payment by the corporation treated as a transfer by a shareholder. While the court's opinion is confusing, it does suggest that a close relationship between an employer and an employee does not prevent the application of section 102(c). The court also seemed to hold that the payment in question did not qualify as a gift without regard to whether section 102(c) applied. *Id.* There seems to be ample justification for the decision not to have the opinion published in the Federal Reporter.

[98] Prop. Reg. § 1.102-1(f)(2), 54 Fed. Reg. 627 (1979).

[99] *Id.*

related parties. Whether an individual is the natural object of a transferor's bounty depends upon their actual relationship rather than on their kinship. An individual might dislike a relative and adore an unrelated individual. It is a subjective test. Note also that there is no mention of related parties in the House Report, which requires only that the gift be made exclusively for personal reasons.[100]

One might question whether the proposed regulation's use of the word "extraordinary" makes that an additional requirement. The regulation does not explain what is meant by that word. The term is not used in the House Report. It is reasonable to conclude that either there is no requirement that a transfer be extraordinary (particularly because the House Report makes no mention of it), or that it means only that the transfer not have a compensatory or business purpose. Instead, the term could mean that a series of transfers cannot qualify and that only an isolated transfer can qualify. But there is no sensible reason for imposing that requirement. For example, employer H makes annual gifts to employee K, who is H's daughter, every Christmas and every birthday. Such gifts might not be deemed extraordinary because they are made regularly every year. There is no reason, however, to deny gift treatment to those gifts merely because they are not isolated transactions. Moreover, the House Report gives "birthday presents" as an example of transfers that qualify. The Report's use of the plural "presents" suggests that multiple gifts can qualify.[101] The crucial question should be whether the transfer is made to the transferee in their capacity as an employee or in some other capacity. The number or size of the transfers may be of evidentiary value, but they are not bright-line designators.

Should a series of transfers that are made to assist an employee who is in dire financial condition be classified as extraordinary? Earlier, this Article referenced a situation where an employer paid the medical bills of a long-time employee who needed medical care that she could not afford. There is no reason to deny gift treatment just because payments were made periodically over some time. A series of payments might raise an inference that they are compensatory, but the taxpayer should be allowed to rebut that inference when the facts indicate a noncompensatory purpose.

Can section 102(c) apply to an employer's payment to a family member of a deceased employee—so-called death benefit payments? Part II discussed whether death benefit payments could qualify as gifts under the *Duberstein* standard and concluded that they could if the payments were not made pursuant to a contract, agreement, or practice of the employer. A death benefit payment is not made to an employee. However, the statute also applies to transfers made "for the benefit of an employee."[102] Can that provision apply when the payment is made after the employee in question has died? The

[100] H.R. Rep. No. 99-426 (1985).
[101] *Id.* at 106 n.5.
[102] *See* I.R.C. § 102(c).

source of the employer's making the payment is the status that the decedent had as an employee before his demise. The payment is made in respect of the decedent. But in what sense can the payment made after the employee's death be said to be of a benefit to the employee? A prominent treatise concluded that the payment cannot be said to be of benefit to the employee unless it was made pursuant to an agreement or plan that existed while the employee was alive.[103] The treatise concludes that, in the absence of such an agreement or practice, section 102(c) does not apply. It notes that the absence of an agreement or practice likely is also a condition for the satisfaction of the *Duberstein* standard; thus, section 102(c) adds nothing to the requirements for gift treatment in the case of death benefit payments.[104]

While the position adopted by the treatise is consistent with the literal language of the statute, the Author disagrees with this conclusion.[105] The tax treatment of death benefit payments was the subject of litigation in a sizeable number of cases prior to the 1986 adoption of section 102(c).[106] Given that one of the apparent purposes for the adoption of section 102(c) was to reduce the amount of litigation that turns on subjective facts by drawing a bright-line distinction, it is highly unlikely that Congress would have wished to limit the provision to transfers to living employees—especially because so much litigation over what constitutes a gift involved death benefit payments. It does not seem an abuse of the statutory language to read "for the benefit of an employee" as incorporating payments made in respect of an employee. The crucial factor should be that the payment arises out of an employment relationship.

To escape from section 102(c), it must be shown that the transferor was not an entity and that the payment was not compensation for the employee's past services. The latter requirement will be difficult to satisfy; it requires showing that a personal, noncompensatory purpose was a necessary and sufficient reason that the payment was made.

A similar question is whether section 102(c) applies to a payment to a retired employee, since the recipient is no longer employed by the payor. There is no apparent reason to doubt that section 102(c) is applicable. Such payments typically are severance pay in recognition of past services. The statute's use of the word "employee" should be construed to include a former employee in light of the legislative purpose to minimize the role of subjective facts in determining whether payments arising out of an employment rela-

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[103] *See* BITTKER & LOKKEN, *supra* note 63, ¶ 10.2.4; *see also* Williams v. Commissioner, 2005-1 U.S.T.C. ¶ 50,163, 95 A.F.T.R.2d 764 (10th Cir. 2005).

[104] *See* BITTKER & LOKKEN, *supra* note 63, ¶ 10.2.4.

[105] Another treatise co-authored by one of the authors of the Bittker and Lokken treatise is ambivalent on this question but seems to favor applying section 102(c) to the payment. *See* BORIS I. BITTKER, MARTIN J. MCMAHON & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.02[4] (3d ed. 2002).

[106] Estate of Carter v. Commissioner, 453 F.2d 61, 66–67 (2d Cir. 1971); BITTKER & LOKKEN, *supra* note 63.

tionship are taxable.[107] So, the payment will be income to the recipient unless it can be shown to have come from an individual who had a personal reason that was both necessary and sufficient to the making of the payment.

B. *Testamentary Transfers to an Employee*

When section 102(c) applies, it prevents section 102(a) from excluding a transfer from gross income.[108] Because section 102(a) applies to both lifetime and testamentary transfers, it would seem that section 102(c) will also apply to testamentary transfers to an employee.[109] There are reasons, however, to conclude that it does not. Neither the regulations nor any other authority addresses that question.

The title to section 102(c) is "Employee gifts"; the title is part of the Act and was not merely an editorial insertion. The title suggests that the provision applies only to gifts. While a testamentary disposition sometimes is referred to as a gift, the fact that section 102(a) refers to "transfers by gift, bequest, devise, or inheritance," whereas the title to subsection (c) refers only to "gifts," indicates that subsection (c) does not apply to testamentary transfers.[110]

How much weight, if any, can be given to the title of a provision? While section 7806(b) states that no inference of legislative purpose should be drawn from the location or grouping of a Code provision, or from the table of contents,[111] that admonition does not apply to the title of a provision—which is as much a part of that provision as is the rest of its language. While the title of a provision should not be conclusive, it is evidence of the scope of the provision. If the restricted scope of the provision that is indicated by the title is supported by the apparent policy for adopting the provision, it should be given greater weight.

As noted in Part II, testamentary transfers to an employee have not caused the administrative and litigation problems that dogged *inter vivos* transfers, where the subjective *Duberstein* standard proved difficult to apply. That is not to say that there were no problems, but they were less troublesome than those attending *inter vivos* gifts. As noted in Part II, there were several cases and a private ruling that excluded a bequest or settlement of a claim against an estate even though there was a prior agreement for services,[112] but those decisions are aberrational. Testamentary transfers have been excluded from income if there was no agreement during the employer's life that a bequest would be made.[113] Moreover, in the absence of a prior agreement, it is likely that a bequest will be motivated by feelings of affection rather than an effort

[107] *See* BITTKER, MCMAHON & ZELENAK, *supra* note 105, ¶ 5.02[3] (preferring the view that section 102(c) applies, but treating the question as an open issue).
[108] I.R.C. § 102(c).
[109] I.R.C. § 102(a).
[110] I.R.C. § 102(a)–(c).
[111] I.R.C. § 7806(b).
[112] *See supra* text accompanying note 75.
[113] *See supra* note 69.

to increase the compensation for past services. Bequests to employees are not unusual in the case of long-term household employees. It would be a rare situation where the bequest is designed to encourage the employee to continue to be employed by the decedent's family, and it is unlikely that that situation would arise frequently enough to stimulate a legislative response.

In the Author's view, the reference in subsection (c) to subsection (a) was a convenient device to remove gifts to employees from the *Duberstein* standard. It is unlikely that Congress noted that the reference to subsection (a) thereby included testamentary transfers. The concededly sparse legislative history contains no mention at all of testamentary transfers. The fact that the title to subsection (c) refers only to gifts provides some support for the view that Congress did not intend for the provision to apply to anything else. While the issue has not arisen, the Author has concluded that section 102(c) does not apply to testamentary transfers.

IV. Conclusion

Some critics of excluding gifts from income have complained that it is unfair to tax workers who earned their income through the sweat of their brow, while not taxing someone who has done nothing more than be the fortunate recipient of another's largess.[114] Although that characterization has superficial appeal, it fails to take into account the reason that gifts are excluded and how that exclusion complements the taxation of income that is saved, rather than consumed, in the year earned. Gifts are not excluded because of the role of the donee; they are excluded in order to allow a taxpayer who has been taxed on income to have a broad range of choices of how that income can be used for consumption of assets or services. Having paid a tax on income, the taxpayer is allowed to use that income for consumption without incurring an additional income tax. Instead of consuming the income himself, a taxpayer may obtain greater utility from having someone the taxpayer loves consume it. The gift exclusion permits the taxpayer to have another person consume the taxpayer's accumulated income. This broadening of the scope of consumption open to a taxpayer is consistent with the taxing of accumulated income, in that the tax on that income represents a tax on consumption that will occur at some future date—even if the consumption is made by someone other than the taxpayer. The reason for excluding gifts focuses on the treatment of the donor rather than the donee. The donee benefits from a policy that maximizes the donor's choice of how his income will be consumed.

On its face, section 102(c) prohibits gift treatment for any transfer from an employer to an employee. However, an examination of the legislative history of that provision, as well as Proposed Regulation section 1.102-1(f)(2), shows that there are exceptions to the application of section 102(c). An employee can occupy more than one status: in addition to being an employee, he can be a beloved relative or friend. If it can be shown that the transfer

[114] *See* Klein, *supra* note 7.

from the employer was made to the recipient in a capacity other than that of an employee, section 102(c) will not apply. To meet that burden, it must be shown that a personal, noncompensatory purpose was the necessary and sufficient reason for the transfer. If section 102(c) does not apply, then the transfer must satisfy the *Duberstein* standard of "detached and disinterested generosity" to qualify as a gift. The Article discusses the conditions that must be satisfied for a transfer to an employee to be excluded from section 102(c) and to qualify as a gift under the *Duberstein* standard. The Author proposes five conditions that must be satisfied. The Article examines the operation of the *Duberstein* standard and concludes that the standard's focus on the intention of the transferor needs to be modified in certain circumstances.

Employee awards for accomplishments such as length or excellence of service cannot constitute a gift because of section 102(c). Consequently, they will be included in income unless another statutory provision excludes them.

Payments made by an entity to an employee can sometimes satisfy the *Duberstein* standard, but it will not be possible for such payments to escape the reach of section 102(c). Consequently, payments from an entity will fail to qualify as a gift. There is a plausible basis for treating an entity's payment as a constructive distribution to an owner of the entity, followed by a transfer from that person to the employee. However, the complications that would follow from that constructive series of transactions make it administratively undesirable to pursue that avenue unless there is strong evidence that the owner was the actual transferor.

Payments made to an employee upon retirement generally will be taxable unless a number of conditions are satisfied that, together, negate the inference that the payment is compensation for past services. Although the transferee is no longer an employee, section 102(c) should apply to the payment since it is attributable to an employment relationship. Even if the difficult hurdle of showing that the payment was not for past services is successfully overcome, if the payment is made by an employer who is an entity it will fail to qualify as a gift.

Death benefits paid to the surviving spouse or other family member of a deceased employee often will qualify for gift treatment under the *Duberstein* standard, unless made pursuant to an agreement or preexisting policy. Contrary to the view of a leading treatise, the Author concludes that death benefit payments are subject to section 102(c). To escape from that provision, it must be shown that the transferor was not an entity and that the payment does not represent compensation for the deceased employee's past services. That latter requirement will be difficult to satisfy. It must be shown that a personal purpose was the necessary and sufficient reason for the transfer. If the decedent's family has financial difficulties, and if there was a close relationship between the employer and the decedent, that would be evidence supporting a claim that the payment was made out of compassion and affection.

The literal language of section 102(c) makes it applicable to testamentary transfers from a deceased employer. The Author concludes, however, that section 102(c) does not apply to them. Accordingly, a testamentary transfer to an employee will not be taxable unless made pursuant to an agreement.