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Taxation-Federal Estate Tax-Application of Section 2039 to Benefits Paid to Survivor Under a Deferred Compensation Plan

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TAXATION—FEDERAL ESTATE TAX—APPLICATION OF SECTION 2039 TO BENEFITS PAID TO SURVIVOR UNDER A DEFERRED COMPENSATION PLAN—Upon decedent's death, his former employer made certain payments to the surviving widow under two voluntarily established benefit plans which were unfunded and non-qualified. The first of these arrangements, the death benefit plan, provided for three months' salary to be paid to an employee's widow, if the employee died before becoming eligible for retirement. The second, the deferred compensation plan, provided payment of a certain stated maximum[1] to an employee's widow in sixty equal monthly installments. This was not a retirement program, however, since the employee himself would receive these payments if, and only if, he were ever to become totally disabled. This arrangement also contained a forfeiture provision whereby all rights would terminate should the employee leave the service of the company for any reason other than death, retirement, or incapacity. The amounts received by the surviving spouse under these two plans were not included in the estate tax return of the decedent's estate. Upon audit, the Commissioner made an additional assessment on the ground that benefits paid under both plans should have been included in the computation of the amount of the gross estate. In an action for refund of federal estate taxes, *held*, dismissed. Under the court's interpretation of section 2039 of the Internal Revenue Code of 1954 and the related Treasury regulations,[2] decedent did possess an enforceable right to payment at some time in the future if certain conditions were fulfilled, and the benefits paid to the beneficiary were therefore properly taxed. Moreover, the death benefit plan and the deferred compensation plan must be viewed as parts of one unified arrangement, and as such the pay-

[1] This plan was adopted for forty of the company's officers and executives. In the decedent's case, the maximum payable to his survivors was $100,000.

[2] "The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement . . . if, under such contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not end before his death." INT. REV. CODE OF 1954, § 2039(a). The related regulations subsequently issued state that the decedent will be regarded as having possessed the right to receive an annuity or other payment if, immediately before his death, he had an enforceable right to receive payments at some time in the future. Treas. Reg. § 20.2039-1(b) (1958).

ments under the former must also be taxed. *Estate of Bahen v. United States*, 305 F.2d 827 (Ct. Cl. 1962).

Prior to the enactment of the 1954 Code, annuities and other employee benefit plans were subjected to the estate tax in a rather sporadic and uncertain fashion. Section 811(a)[3] (predecessor to section 2033) dealing with *property* in which decedent had an interest, section 811(c)[4] (predecessor to sections 2036 and 2037) covering inter vivos *transfers* of a testamentary nature, and section 811(d)[5] (predecessor to section 2038) concerning revocable *transfers* were the commonly invoked provisions of the 1939 Internal Revenue Code in attempts to tax benefit plans as part of a decedent's estate.[6] Under the terms of many such plans, however, all rights of both employee and beneficiary were forfeitable upon certain conditions such as termination of employment,[7] or competition with employer.[8] When the Commissioner attempted to include payments under these schemes as part of a decedent's gross estate, the often-raised objection was that decedent had no *property* interest which could be transferred, but rather a mere expectancy. Although the decisions were not entirely in harmony,[9] the raising of this objection generally met with success.[10] It was felt that the decedent simply did not possess the kind of property interest required by section 811 for these benefits to be properly included in his gross estate.[11] With this uncertain tax status of employee annuities and benefit plans as a background, section 2039 of the 1954 Internal Revenue Code was enacted as the first attempt to cover these arrangements specifically.[12] Although the necessity of a property interest in the decedent or a transfer by the decedent is noticeably absent from this provision, it does require that "the decedent possessed the right to receive such annuity or other payment . . . for his life . . . or for any period which does not in fact end before his death." Yet, after the enactment of the 1954 Code, the status of benefit payments under plans in which the interest of the decedent was contingent remained unclear. Many felt that the

3 Int. Rev. Code of 1939, ch. 3, § 811(a), 53 Stat. 119.

4 Int. Rev. Code of 1939, § 811(c), as amended, ch. 512, 67 Stat. 623 (1953).

5 Int. Rev. Code of 1939, § 811(d), as amended, ch. 512, 67 Stat. 623 (1953).

6 *E.g.*, Commissioner v. Wilder's Estate, 118 F.2d 281 (5th Cir.), *cert. denied*, 314 U.S. 634 (1941); Estate of Emil A. Stake, 11 T.C. 817 (1948).

7 See, *e.g.*, Estate of Albert B. King, 20 T.C. 930 (1953).

8 See, *e.g.*, Goodman v. Granger, 243 F.2d 264 (3d Cir.), *cert. denied*, 355 U.S. 835 (1957).

9 See, *e.g.*, Estate of Charles B. Wolf, 29 T.C. 441 (1957), where the court held that decedent did possess enforceable vested rights notwithstanding the fact that these rights were subject to forfeiture.

10 *E.g.*, Molter v. United States, 146 F. Supp. 497 (E.D.N.Y. 1956); Dimock v. Corwin, 19 F. Supp. 56 (E.D.N.Y. 1937), *aff'd on other grounds*, 99 F.2d 799 (2d Cir. 1938); Estate of Albert L. Salt, 17 T.C. 92 (1951); Estate of M. Hadden Howell, 15 T.C. 224 (1950).

11 See Note, 67 YALE L.J. 467 (1958).

12 For an excellent article on the basic changes in the area of estate taxation which occurred with the 1954 Code, see Bittker, *Estate and Gift Taxation Under the 1954 Code: The Principal Changes*, 29 TUL. L. REV. 453 (1955).

"expectancy" argument would often prevent inclusion of the benefit payments in the gross estate, as it had under the 1939 Code.[13]

The Treasury regulations, issued as an attempt at clarification,[14] were only partially successful. The enforceable right to payment which section 2039 requires was interpreted as including an enforceable right to payment at some time in the future. The regulations also made it clear that forfeiture provisions (*i.e.*, conditions subsequent), by themselves, would no longer prevent estate taxation, since decedent would be deemed to have an enforceable right so long as he had met the obligations under the agreement up to the time of his death. In its application of section 2039 and the related regulations, the court in the principal case determined that the decedent's conditional right to receive payments under the deferred compensation plan was an enforceable right to receive payments at some time in the future as required. He had met all of his obligations to date, and hence had the required interest.[15] Moreover, the regulations state that payment may be conditional or unconditional; hence, the court felt that the fact that decedent had a mere expectancy was of no importance. However, the regulations speak of the *payment* as being conditional or unconditional, rather than the *right* to the payment being conditional or unconditional. While it is not entirely clear what specific types of plans are meant to be encompassed by this language, it arguably could indicate only that conditions subsequent, as distinguished from conditions precedent, will not justify the exclusion of an otherwise includible interest. When the regulations speak of "meeting obligations," forfeitures (*i.e.*, conditions subsequent) seem to be the type of provisions contemplated.[16] Moreover, it appears that the distinction between conditional rights and conditional payments was felt to be important by some, for even after the appearance of these regulations some writers indicated a belief that benefits paid to a survivor still might escape estate taxation if the decedent's interest was subject to a condition precedent.[17]

The language of section 2039, however, is quite similar to that found in section 2036,[18] which deals with retained life estates. Indeed, the sponsoring Senate committee's report specifically directs that the rules applicable to section 2036 shall apply to section 2039 for the purpose of determining

13 *E.g.*, 2 MERTENS, FEDERAL ESTATE AND GIFT TAXATION § 18.11 (1959). *But see* STEPHENS & MARR, FEDERAL ESTATE AND GIFT TAXES 109 (1959).

14 Treas. Reg. § 20.2039 (1958).

15 Since decedent's interest was subject to a forfeiture provision, meeting his obligations up to the time of his death did have some bearing on the situation.

16 "[T]he decedent will be regarded as having had 'an enforceable right to receive payments at some time in the future' so long as he had complied with his obligations under the contract or agreement up to the time of his death." Treas. Reg. § 20.2039-1(b)(1)(ii) (1958).

17 2 MERTENS, *op. cit. supra* note 13, §§ 18.11-.12; Kramer, *Employee Benefits and Federal Estate and Gift Taxes*, 1959 DUKE L.J. 341.

18 ". . . a transfer . . . under which [the transferor] has retained . . . the possession or enjoyment of, or the right to the income from the property." INT. REV. CODE OF 1954, § 2036(a).

whether the decedent possessed the right to receive the "annuity or other payment."[19] The few analogous cases involving section 2036 have dealt with situations in which the decedent made an inter vivos transfer retaining a contingent life estate.[20] These cases have generally held that the decedent does retain the right to income, even though the possibility of receiving the income is conditioned upon the decedent surviving a present life beneficiary.[21] Since this interest retained by the decedent could be described as a life estate subject to a condition precedent, by applying similar reasoning to the language of section 2039 it would seem that the proceeds paid to the decedent's survivor would be includible in his gross estate, even if the decedent possessed only a contingent right to receive them. Moreover, by ignoring arguments based upon abstract and conceptual property law distinctions,[22] and adhering to the more apparent meaning and overall purpose of section 2039, the principal case reflects a realistic economic attitude toward these employee benefit arrangements.[23] The Treasury regulations have made it clear that proceeds paid through plans under which the decedent possessed an interest subject to a condition subsequent will be includible in the decedent's gross estate. Indeed, it would be difficult to conceive of an arrangement whereby through careful draftsmanship the decedent's interest could not be made subject to a condition precedent rather than a condition subsequent. Hence, for estate tax purposes a distinction between the two does not seem justified. Moreover, programs of this type are in essence a form of compensation to the employee which differs from his salary only in the manner paid. By providing an annuity or other payment scheme for an employee's family, the employer has assumed part of a burden which otherwise would have been borne by the employee himself. Amounts received through an organized plan by the typical deceased employee's family generally are not paid out of the goodness of the employer's heart, but rather pursuant to an obligation for which the employee has bargained.

While subtle differences between types of interests might be of para-

19 "The rules applicable under 2036 in determining whether the annuity or *other* payment was payable to the decedent, or whether he possessed the right thereto, for his life or such periods shall be applicable under this section." S. REP. No. 1622, 83d Cong., 2d Sess. 472 (1954).

20 Commissioner v. Arents' Estate, 297 F.2d 894 (2d Cir.), *cert. denied*, 369 U.S. 848 (1962); Marks v. Higgins, 213 F.2d 884 (2d Cir. 1954).

21 This situation would occur when a donor directs that the income payments be made to himself should a named beneficiary predecease him. For a clear example of this and the usual holding, see Commissioner v. Nathan's Estate, 159 F.2d 546 (7th Cir. 1947), which was decided under § 811(c) of the Internal Revenue Code of 1939 (predecessor to § 2036).

22 Minute distinctions between various levels of property interests, however, should have no application in estate taxation. Helvering v. Hallock, 309 U.S. 106, 118 (1940).

23 The exemption of certain "qualified" plans from the application of § 2039, and the disregard for economic and moral pressures which make many forfeiture conditions illusory, have been subject to substantial criticism. See, *e.g.*, Pincus, *Estate Taxation of Annuities and Other Payments*, 44 VA. L. REV. 857 (1958).

mount importance to the lawyer steeped in the technicalities of property law, the instant decision appears to have effectively erased whatever remained of the expectancy theory. Under this new statutory provision, as interpreted by the court in the principal case, it is apparent that if the decedent possesses *any* right to future payment[24] the benefits paid to a survivor must be included in the gross estate of the decedent.

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[24] If the value of the decedent's chance to enjoy his interest is extremely minute as compared to the total value of the benefits eventually realized, the same problems as were seen under § 2037 prior to the addition of the 5% rule will be encountered under § 2039.