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TAXATION - FEDERAL INCOME TAX - DEFERRED COMPENSATION AS AFFECTED BY CONSTRUCTIVE RECEIPT DOCTRINE

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TAXATION — FEDERAL INCOME TAX — DEFERRED COMPENSATION AS AFFECTED BY CONSTRUCTIVE RECEIPT DOCTRINE—Prior to his retirement as a general agent of a life insurance company, the petitioner entered into a new contract¹ with the company by which he was to receive upon retirement fixed monthly instalments for fifteen years in lieu of his original contract rights to receive renewal premium commissions as they were paid into the company. Petitioner, as a cash basis taxpayer, reported as income only the instalments received. The Commissioner assessed deficiencies in the reports, contending that petitioner's taxable income consisted of all renewal commissions received by the company during the taxable year, rather than the instalment payments.² Rejecting the Commissioner's argument that the constructive receipt doctrine was applicable to the renewal commissions, the Tax Court upheld the petitioner's challenge of the assessment of the deficiencies.³ On appeal, *held*, affirmed. Since the new contract calling for fixed monthly instalments was a binding substituted contract, the taxpayer had no contractual right to the additional renewal commissions. Therefore the constructive receipt doctrine was inapplicable and only the fixed monthly instalments were income to the taxpayer. *Commissioner v. Oates*, (7th Cir. 1953) 207 F. (2d) 711.

¹ See James Oates, 18 T.C. 570 (1952), for an extensive discussion of the contract negotiations which resulted in this deferred compensation plan.

² Under the original contract, the petitioner would have received approximately \$67,500 for the first two years and seven months following retirement. But by his election to take payments under the monthly instalment plan, he received in fact \$1,000 monthly for the thirty-one months. James Oates, note 1 *supra*, at 582.

³ James Oates, note 1 *supra*. The Commissioner has given notice of non-acquiescence in this decision. See 1952-2 Cum. Bul. 5.

The typical deferred compensation agreements, which are usually designed to re-allocate or postpone the payments of income, have frequently been tested by the doctrine of the constructive receipt of income.⁴ This doctrine, as set forth in the famous *Horst* case,⁵ is basically a means for designating certain economic transactions as the realization of taxable income⁶ even though the taxpayer does not receive the payment of income in the form of money or property. The realization of such income is said to arise by the taking of the last step necessary to obtain the fruition of the economic gain which has already accrued to the taxpayer.⁷ Repeated attempts by the Commissioner to apply the constructive receipt doctrine to deferred compensation agreements or plans similar to the one in the principal case have been unsuccessful.⁸ Generally, the Commissioner takes the position that the taxpayer should be taxed on the income he would have received in a given tax year had he not entered into an agreement by which his actual receipt of income was allocated over several years or in a different manner. The various decisions recognizing for tax purposes the validity of the deferred compensation plans have distinguished the *Horst* case by stating that the taxpayer under his new agreement has no present rights or control of the income.⁹ Rather, the taxpayer has only a contractual right¹⁰ to demand and collect these monies as they become due under the new agreement and his taxable income coincides with the actual receipt of payments under the agreement.¹¹ Therefore, if there is

⁴ For excellent discussions of this general problem see 45 ILL. L. REV. 77 (1950); 31 TAXES 1007 (1953).

⁵ *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144 (1940). The Supreme Court ruled that the delivery of interest coupons maturing in the taxable year to the donee who then collected them constituted the realization of income to the donor and was taxable to the donor. See also *Treas. Reg. 118, §39.42-2*.

⁶ "The doctrine of constructive receipt was, no doubt, conceived by the Treasury in order to prevent a taxpayer from choosing the year . . . in which to reduce it to possession. Thereby the Treasury may subject income to taxation when the only thing preventing its reduction to possession is the volition of the taxpayer." Justice Frankfurter in *Ross v. Commissioner*, (1st Cir. 1948) 169 F. (2d) 483 at 491.

⁷ For a collection of cases involving the principle of constructive receipt of income see *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241 (1930); *Helvering v. Eubank*, 311 U.S. 122, 61 S.Ct. 149 (1940); *Burns v. Commissioner*, (5th Cir. 1929) 31 F. (2d) 399; *Alexander Zolotoff*, 41 B.T.A. 991 (1940); *Walter I. Bones*, 4 T.C. 415 (1944).

⁸ See *Howard Veit*, 8 T.C. 809 (1947); *Kay Kimbell*, 41 B.T.A. 940 (1940); *James D. Mooney*, 9 T.C. 713 (1947); *Adolph Zukor*, 33 B.T.A. 324 (1935).

⁹ However, a showing that a bonus is subject to the unfettered command of an executive will result in the application of the constructive receipt doctrine. *Richard R. Dupree*, 1 T.C. 113 (1942).

¹⁰ On the issue of consideration for the deferred compensation contract, the court stated in the principal case at 712: "The extinguishment of the original obligation was consideration for the new agreement and the new promise consideration for the release of the old, each being consideration for the other."

¹¹ The strongest authority for the taxpayer in the principal case was *Howard Veit*, note 8 supra. In that case, the taxpayer was entitled to a bonus payable on October 1, 1941. On June 18, 1941 the taxpayer agreed to a postponement of payments until 1942, at which time he would be paid in four equal instalments. The application of constructive receipt was denied. Thus the agreement was given full recognition with the result that the bonus was not considered as income for 1941. For an interesting sequel to this case see *Howard Veit*, 8 T.C.M. 919 (1949).

compliance with several requirements established by judicial decision, the deferred compensation agreement will not be subject to an application of the constructive receipt doctrine. One requirement is that the new contract for deferred compensation must be prior in time to the right of the taxpayer to receive the compensation under the original contract.¹² A matured right to receive compensation would thereby invalidate for tax purposes any agreement to defer payment of that compensation, but contractual arrangements re-allocating future rights to compensation or income will be given full recognition.¹³ Another requirement is an indication that the negotiations for the deferred payments were at arm's length and in good faith;¹⁴ with such a showing, the possibility that the deferred compensation plan was motivated in part by a desire to minimize or postpone the payment of taxes apparently becomes immaterial. To satisfy this requirement the decision in the principal case emphasizes the long negotiations between the agents and the insurance company together with the dissatisfaction of the agents over the inconvenience and hardship accompanying the constantly decreasing payments under the original contract. Evidence that the agreement was at the request of the employer rather than the taxpayer will help establish good faith.¹⁵ In essence any uncontradicted testimony by the parties to the contract indicating a bona fide agreement will suffice.¹⁶ Although the case authority is meager and unsupported by a Supreme Court decision, it appears that deferred compensation agreements will continue to receive sympathetic treatment by the courts.

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¹² In the principal case the petitioner had to elect at retirement whether to take the renewal premiums under the original contract or to abide by the deferred compensation plan, and the election was then irrevocable.

¹³ Apparently undecided is the question of whether an agreement for the payment of a bonus or compensation could be altered and accorded full recognition after part of the payments had been made.

¹⁴ See Howard Veit, note 8 *supra*, at 816; Kay Kimbell, note 8 *supra*, at 948; James Oates, note 1 *supra*, at 574.

¹⁵ Howard Veit, note 11 *supra*, at 922.

¹⁶ Kay Kimbell, note 8 *supra*, at 948.