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Tax: The Importance of Employee Involvement in Determining Own Method of Compensation Reviewed

Respondent physicians were partners in a limited partnership called Permanente Medical Group (Permanente) which was organized in California in 1949 for the purpose of practicing medicine. Permanente had contracted with Kaiser Foundation Health Plan, Inc. (Kaiser)¹ to provide exclusive medical care to the members of Kaiser. In return, Kaiser was to make both monthly compensation payments directly to Permanente and periodic payments to a retirement trust plan for the partner and non-partner physicians of Permanente when and if such a plan should be established. A retirement plan² was subsequently established by a trust agreement between the parties. Under this agreement, Kaiser's periodic payments were to be made directly to a trust fund³ where they would be allocated to the tentative trust accounts of each eligible participating physician.⁴ Prior to retirement, no participant was to receive any benefits, and his interest was subject to a number of contingency provisions. For example, if a participant were to terminate his association with Permanente for reasons other than death or disability before attaining the age of 65 or retire before completing 15 years of continuous service and fail to reassociate with some other medical group serving Kaiser, he would forfeit all benefits from the trust.⁵ Any forfeited amounts were to be re-

¹. Kaiser is a California nonprofit corporation which provides prepaid hospital and medical care to its dues-paying members.
². Throughout this Comment, the retirement plan and the corresponding trust fund will be characterized as unqualified under Int. Rev. Code of 1954 § 401. Even a cursory reading of section 401 would indicate why such a classification is justified. For example, this plan violates the very basic provision against discrimination in favor of highly compensated employees. See Int. Rev. Code of 1954, § 401(a)(4); Treas. Reg. § 1.401-4 (1963).
³. The parties stipulated that "[t]he payments which [Kaiser] agreed to, and did make to the trust, were paid solely to fund the retirement plan, and were not otherwise available to [Permanente] or to the individual members or employees thereof." Basye v. United States, 450 F.2d 109, 114 (9th Cir. 1971).
⁴. Any partner or employee physician of Permanente with a minimum of two years of service with the partnership was eligible to participate in the retirement trust. Each participant was assigned a certain number of units based on age, length of service, etc. On the basis of these units, payments from Kaiser were distributed to the participants' tentative trust accounts.
⁵. Benefits could also be forfeited by unreasonable refusals to
distributed among the other beneficiaries of the trust. Once payments were made to the trust, they were thereafter committed exclusively to the benefit of Permanente's participating physicians and Kaiser could never recoup them. During the four years at issue, neither Permanente nor any of the individual partners included any part of Kaiser's trust payments in their reported gross incomes.

The Commissioner of the Internal Revenue Service determined that the failure to include Kaiser's trust payments in the partnership's gross income had resulted in an understatement of partnership income and deficiencies in the tax returns of each of the partners for the years 1960 through 1963. The Commissioner did not contend that the partners were required to recognize income on the basis of accumulations in their tentative trust accounts. Rather, it was asserted that the direct payments to the trust represented compensation to Permanente and were therefore taxable to the partners on the basis of their distributive share of that partnership income. The partners paid their assessments and filed a consolidated action for refund. Both the district court and the court of appeals disagreed with

provide consulting services to Kaiser after retirement or by providing services to a competitor of Kaiser at any time. If Permanente were dissolved or reorganized and more than 50 percent of the trust participants reassociated with some other medical group serving Kaiser members, those who failed to reassociate would forfeit all benefits to the remaining participants. If less than 50 percent reassociated, the trust would be liquidated and the proceeds distributed to all participants.

6. A partnership is not a taxable entity, but it must file a return with the Internal Revenue Service in compliance with Int. Rev. Code of 1954, § 6031.

7. Permanente reported its income on the accrual basis while all the partners used the cash basis method for reporting their income.

8. It is well established that a taxpayer who is the beneficiary of an unqualified retirement plan which is funded by a trust is not to be taxed for contributions made to the trust if his beneficial interests are forfeitable. Treas. Reg. § 1.402(b)-1(a) (1966) reads in relevant part:

[A]ny contribution made by an employer on behalf of an employee to a trust . . . not exempt under section 501(a) [an unqualified plan], shall be included in income of the employee for his taxable year during which the contribution is made if the employee's beneficial interest in the contribution is nonforfeitable . . . .

See also S.J. Coppola v. Commissioner, 35 T.C. 405 (1960); Robertson v. Commissioner, 6 T.C. 1060 (1946).


10. Basye v. United States, 295 F. Supp. 1289 (N.D. Cal. 1968). The district court ruled that since Permanente could not have received the same funds as direct compensation (see note 3 supra), the payments to the trust were not the result of anticipatory assignment of partner-
the Commissioner's ruling that Kaiser's payments to the trust had resulted in current income to the partnership. On appeal, the United States Supreme Court reversed, holding that the payments by Kaiser did in fact constitute accrued income to Permanente and that the respondents, as partners, were currently taxable on their distributive share of that income. *United States v. Basye*, 410 U.S. 441 (1973).

The Court's decision contains three main elements. First, it determined that the taxability of the payments should be ascertained by viewing the partnership as an entity and not as a mere conduit. Second, the Court held that payments to the trust did in fact constitute current partnership income and that Permanente could not avoid reporting them as such merely because they were paid directly to the trust. Finally, as a consequence of finding that the payments were current partnership income, the Court concluded that the partners could not avoid taxation on their distributive shares merely because that income might never be distributed to them.

The Court's holding that the partnership was to be viewed as a separate entity for the purpose of computing current partnership income would hardly merit discussion were it not for the apparent confusion in the two lower courts on this issue. Although there is little case law on point, numerous commentaries have invariably concluded that a partnership should be viewed as

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11. *Basye v. United States*, 450 F.2d 109 (9th Cir. 1971). The ruling of the court of appeals was identical to the decision below except that the second alternative holding was omitted.

12. Under the entity approach, the existence of an obligation to report any given item as income is determined by viewing the partnership as an entity separate from the individual partners. In this way, items of income which may be forfeitable with respect to any individual partner but are not forfeitable with respect to the partnership as a whole constitute reportable income. The conduit approach, on the other hand, would view these same items of potential income as merely flowing through the partnership so that an item which is not attributable to any one partner as current income would not be reportable as partnership income either. See 6 Ind. L. Rev. 537, 540 n.17 (1973).

13. The issue is discussed by the appellate court, 450 F.2d at 113-15, and by the district court, 295 F. Supp. at 1295. The Supreme Court found it odd that this issue should even be discussed at this late date. 410 U.S. at 448 n.8.
as an entity when computing its income. In any case, section 703(a) of the Internal Revenue Code makes it quite clear that the Court has only reiterated what was already the established law.

The third component of the Court's ruling concerning the taxability of undistributed partnership income to the individual partners is as unmomentous as the first and merits only a limited discussion. The fundamental case law in this area was succinctly articulated as long ago as 1938 in Heiner v. Mellon, where the Court said:


15. INT. REV. CODE of 1954, § 703(a) provides in relevant part: "The taxable income of a partnership shall be computed in the same manner as in the case of an individual . . . ."

16. The basis for the confusion seems to be that those who suggest the conduit approach rely on INT. REV. CODE of 1954, § 702(b) which provides:

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share [of partnership income] . . . . shall be determined as if such item were realized directly from the source from which realized by the partnership . . . .

The advocates of the conduit approach evidently interpret this section to mean that the characterization of an item of income as income to the partners is to be determined on the assumption that the item is being received directly from the source. If, for example, the income is in the form of forfeitable benefits from a trust (as in the Basye case), it should then not be characterized as income to the partner. Such a reading of the statute is plausible but certainly incorrect. The statute is meant to be interpreted so that once income is realized by the partnership and the partners' distributable shares are determined, the individual partners will stand in the shoes of the partnership when characterizing the items of income on their respective tax returns. See Treas. Reg. § 1.702-1(b) (1966). This idea is illustrated in the Court's opinion in Basye:

For this purpose [determination of partnership income], then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.

410 U.S. at 448.

17. 304 U.S. 271 (1938). In this case, taxpayers were the surviving partners of a three-man partnership. In the process of liquidating the partnership, the taxpayers accrued income and were forced to pay tax on their distributable shares even though state law prevented them from
The tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it might not be currently distributable, whether by agreement of the parties or by operation of law, is not material.18

Once Kaiser's payments to the trust are characterized as reportable partnership income, the law conclusively establishes the individual partner's tax liability for his distributive share whether or not he ever receives it.19 The Court's decision on this issue is noteworthy only in that it affirms Treasury Regulation 1.702-1(a).20

The second element of the Court's decision, however, represents an important delineation of a taxpayer's liability for income he has been prevented from receiving because of contractual limitations. The Court based its conclusion of taxpayer liability on the concept of anticipatory assignment of income. This doctrine requires that the tax on income must be paid by the individual who earns it21 and "that the tax [can] not be escaped receiving their shares until the liquidation was complete. It should also be noted that they could quite possibly have incurred future losses which might have consumed all the partnership income on which they had been taxed.

18. Id. at 281.
19. This concept has been consistently applied. See Hulbert v. Commissioner, 227 F.2d 399 (7th Cir. 1955); Bell v. Commissioner, 219 F.2d 442 (5th Cir. 1955); Stewart v. United States, 263 F. Supp. 451 (S.D. N.Y. 1967); Freudmann v. Commissioner, 10 T.C. 775 (1948). See also Stoumen v. Commissioner, 208 F.2d 903 (3d Cir. 1953). The respondents argued, however, that the phrase in the 1939 Code on which most of the decisions on this issue were based is not found in the 1954 Code, and that it is therefore no longer justifiable to tax partners on all of their distributive share of partnership income regardless of uncertainties as to the eventual receipt of those shares. See Brief for Respondents at 10, 33, United States v. Basye, 410 U.S. 441 (1973). However, the respondents' argument is quickly disposed of by the fact that the deleted phrase is now found in Treas. Reg. § 1.702-1(a) (1966), the relevant portion of which reads as follows:

Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income . . . .

If the Court had allowed the partners to postpone the reporting of the trust payments until their individual rights to such payments became vested, it would have thrown the law of partnership taxation into utter chaos. All partnership agreements would soon provide for various items of partnership income to be held in suspension for income tax purposes until the rights of the individual partners would vest. This would permit a substantial tax advantage clearly beyond the intent of the Court or the Code. See Teschner, Basye Projected: Fringe Benefits and the Supreme Court, 51 Taxes 324, 334 (1973).

20. Treas. Reg. § 1.702-1(a) (1966). The phraseology of this regulation is the basic component of most decisions in the area. See note 19 supra.
21. See, e.g., Commissioner v. Culbertson, 337 U.S. 733 (1949); Na-
by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.” 22 In Basye, the application of the anticipatory assignment concept required that income earned by Permanente not go unreported merely because the trust agreement stipulated that it was to be paid directly to the trust rather than to Permanente itself. The Court refused to even consider the argument that the individual partners, rather than Permanente, had or would have earned the income through their long term service to Kaiser. 23 Instead, the Court held that Permanente had unquestionably earned the income being distributed by Kaiser in the form of the trust payments. 24

Merely ruling that Permanente had earned the income, however, was not enough to dispose of the case. In Commissioner v. First Security Bank of Utah, 25 the Court had recognized that

22. Lucas v. Earl, 281 U.S. 111, 115 (1930). The taxpayer in this case had entered into a contract and assigned one-half of all his current interests plus one-half of all future interests to his wife. The question litigated was whether the assignment of current income to the wife could successfully excuse the taxpayer from reporting the income in his annual tax return. The Court disallowed such tax avoidance.

23. This argument was in fact used by the appellate court in its decision:

The payments are to be viewed not as compensation for immediately past medical services but as compensation for the continued, long-term services of individual physicians. When the transaction is viewed in this light the partnership becomes a mere agent contracting on behalf of its members for payments to the trust for their ultimate benefit, rather than a principal which itself realizes taxable income.

450 F.2d at 115.

As contingent beneficiaries of an unqualified retirement plan, the partners would have escaped current taxation under Treas. Reg. § 1.402 (b)-1(a) (1966). See note 30 infra.

24. 410 U.S. at 449.

25. 405 U.S. 394 (1972). The taxpayer in this case was a bank offering insurance to its borrowers. Under 12 U.S.C. § 92 (1916), national banks were authorized to act as insurance agents when located in places having a population not exceeding 5000. By negative implication, the courts have held that this provision prohibited such dealing in places of more than 5000 inhabitants. See Saxon v. Georgia Ass’n of Independent Ins. Agents, Inc., 389 F.2d 1010 (5th Cir. 1968); Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966). Although section 92 has been repealed, the Comptroller of the Currency still considers that section to be effective as of 1972. See 405 U.S. at 401 n.12. As a bank, the taxpayer was thus prohibited from receiving sales commissions from the insurance carrier which was an affiliated corporation. The Court, per Justice Powell, held that since the bank could not legally receive the
a taxpayer need not report income which it had earned if it was prohibited by statute from receiving the income. Also, the Court in that case cited with approval26 Teschner v. Commissioner,27 in which the Tax Court had held that money earned by the taxpayer was not includable in taxable income because a contractual stipulation prevented the taxpayer from directly receiving the income.

In the area of anticipatory assignment law, the First Security Bank case and the Court's endorsement of Teschner seemed to limit the strict application of the concept that income must always be taxed to the person who earns it. On the basis of these two recent decisions, it appeared that a taxpayer would not be required to report compensatory income which he could never receive because of either a contractual provision or a statutory limitation.28 Yet the Court reached the opposite result in Basye where the agreement clearly prohibited Permanente from ever directly receiving the trust payments.

The operative distinction between Basye and the First Security Bank and Teschner cases is that in the latter cases the taxpayers in no way bargained for the legal limitations which prevented the direct receipt of compensation. In Basye, however, Permanente was involved in establishing the trust agreement which prevented it from receiving the trust payments directly. This factual distinction was crucial to the Court's decision. Since Permanente was a party to the trust agreement under which it was prevented from receiving the trust payments directly, it was necessary to report those payments to the trust as current partnership income.29 Thus, the decision in Basye indicates that anticipatory assignment of income exists as a matter of law whenever the taxpayer is not completely independent of the circumstances which deprive him of the right to receive compensation directly, and that such compensation must be re-

26. 405 U.S. at 406 n.22.
27. 38 T.C. 1003 (1962). The taxpayer in this case had entered a contest which precluded him from being the recipient of any prizes awarded but allowed him to compete if he would name a child under 17 to be the recipient of any prizes he might win. The court held that since the taxpayer never had and never would have the right to receive the prizes himself, it would be unfair to require him to report such prizes as income.
ported as current income\textsuperscript{30} regardless of the taxpayer's apparent inability\textsuperscript{31} to receive the compensation directly.\textsuperscript{32}

The Court's holding may be explained in either of two ways. The inappropriate explanation would be that the Court was persuaded by the Government that to find for the taxpayers would disrupt the statutory limitations on unqualified retirement plans under sections 401 through 404 of the Internal Revenue Code.\textsuperscript{33} The Government had argued\textsuperscript{34} that since this retirement plan

\textsuperscript{30} It should be noted that if the respondents had not been the members of a partnership but had contracted with Kaiser as a group of employees, they could have set up the identical retirement plan and would only have been taxed when they actually received nonforfeitable interests in the trust. Treas. Reg. § 1.402(b)-1(a) (1966). \textit{See} Robertson v. Commissioner, 6 T.C. 1060 (1946), where the petitioner was a participant in an unqualified retirement plan and had a \textit{forfeitable} interest in the plan's trust fund which was funded by the employer. If the petitioner were to forfeit his interest, it was to be redistributed among the other members of the plan. In no way could the employer recoup the trust payments once they were made. Relying on Int. Rev. Cods of 1939, § 165(c), the predecessor of Treas. Reg. § 1.402(b) (1966), the court ruled that the taxpayer was not taxable on the contributions as long as they were actually forfeitable. \textit{See also} Rev. Rul. 67-449, 1967-2 Cum. Bull. 173.

\textsuperscript{31} That Permanente could not have received the payments in any other form is apparent from the stipulated facts. \textit{See} note 3\textsuperscript{supra}.

\textsuperscript{32} This conclusion seems justified on the basis of the following statements in the Court's opinion:

The [appellate] court's reasoning seems to be that, before the partnership could be found to have received income, there must be proof that "Permanente agreed to accept less direct compensation from Kaiser in exchange for the retirement plan payments." [450 F.2d] at 114-115. Apart from the inherent difficulty of adducing such evidence, we know of no authority imposing this burden upon the Government. Nor do we believe that the guiding principle of Lucas v. Earl may be so easily circumvented. Kaiser's motives for making payments are irrelevant to the determination whether those amounts may fairly be viewed as compensation for services rendered. Neither does Kaiser's apparent insistence upon payment to the trust deprive the agreed contributions of their character as compensation. The Government need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received.

410 U.S. at 451-52.

\textsuperscript{33} There is some evidence that the Court was swayed by this argument:

We may assume, especially in view of the relatively unfavorable tax status of self-employed persons with respect to the tax treatment of retirement plans, that many partnerships would eagerly accept conditions similar to those prescribed by this trust in consideration for tax-deferral benefits of the sort suggested here.

410 U.S. at 452. It should be noted, however, that the unfavorable status referred to by the Court concerns qualified plans under section 401 and is not applicable to unqualified plans.

\textsuperscript{34} \textit{See} 41 U.S.L.W. 3338 (1972).
was admittedly an unqualified plan, it should not be allowed one of the principal benefits of the qualified plans—deferment of taxes for the beneficiaries of the trust. However, beneficiaries of an unqualified trust must only include as income their share of contributions which are nonforfeitable. The partners' beneficial interests in the trust were certainly forfeitable. Therefore, it could be argued that to allow each partner to defer the reporting of the trust benefits as current income until his respective rights became vested would in fact be compatible with the statutory provisions concerning deferred compensation plans.

It is more likely that the Court ruled as it did in order to avoid setting a precedent that would prove to be unworkable. As noted earlier, the factual distinction between this case and the First Security Bank and Teschner cases was that Permanente was actually involved in negotiating the agreement which prevented it from ever receiving the compensation directly. Certainly a taxpayer should not be forced to report compensation it could never actually receive. In a fact situation similar to Basye, however, where the taxpayer is actually involved in the arrangement which prevents it from directly receiving the compensation, the problem becomes one of practicality. It would be unlikely that the courts could ever determine from the available facts whether the taxpayer actually could not have received the compensation directly or whether it instead merely agreed to have the compensation paid to someone or something else in order to avoid taxation. The Court quite clearly saw

36. Id. The reader may be confused at this point as to what tax advantages result from having a qualified retirement plan and trust fund if the unqualified plans result in tax deferral for the beneficiaries. The basic advantage is the simultaneous occurrence of tax deferral for the beneficiaries and current tax deductibility for the employer. If the beneficiaries' interests under an unqualified plan are forfeitable, they may escape current taxation under section 402(b), but the employer will not be allowed a deduction for his contribution. See Treas. Reg. § 1.404(a)-12 (1960) which reads in relevant part:

[I]f an amount is paid during the taxable year to a trust or under a plan and the employee's rights to such amounts are forfeitable at the time the amount is paid, no deduction is allowable for such amount for any taxable year.

For a discussion of why the Court held that the individual partners were currently taxable on the clearly forfeitable trust payments despite the apparent sanction of Treas. Reg. § 1.402(b)-1(a) (1966), see note 19 supra.
37. As indicated in note 3 supra, Permanente had no choice but to receive the compensation in the form of payments directly to the trust.
the need to react at the first indication that a theory of tax avoidance was being developed that would effectively destroy all anticipatory assignment law,\textsuperscript{38} law which the Court considers to be the "cornerstone of our graduated income tax system."\textsuperscript{39}

In \textit{Basye} the Court's conclusion of bargained-for compensation was predicated on the fact that Permanente had "prior involvement" with the trust arrangement which resulted in a diversion of partnership compensation to the trust.\textsuperscript{40} It is interesting to consider the extent to which this argument of prior-bargaining-therefore-taxation could be invoked in other areas of tax law.

**BASYE AS APPLIED TO FRINGE BENEFIT PROGRAMS**

Fringe benefit programs appear to be one analogous situation where this concept could have some application. Permanente's prior involvement with the trust agreement was held to be sufficient bargaining for the disposition of its compensation to result in currently reportable income; similarly, the employee who bargains with the employer for the terms of his employment contract might also be forced to report compensation directly or indirectly conferred under that contract. However, most major fringe benefit programs are already directly regulated in the Internal Revenue Code. For example, stock option plans,\textsuperscript{41} annuities,\textsuperscript{42} health and accident plans,\textsuperscript{43} and group-term insurance plans\textsuperscript{44} are all explicitly controlled under the Code.

One type of fringe benefit program which has not yet been explicitly circumscribed by the Code is the "college benefit

\textsuperscript{38} The Court itself contributed to the development of such a theory when it stated:

\begin{quote}
We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving.
\end{quote}

Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972). When applying the doctrine of assignment of income, this language appeared to create a factual question as to whether a taxpayer is actually prohibited from receiving the income. The Court in \textit{Basye} obviously concluded that it would have been a fatal error to rest the determination of taxability on a factual issue where only the taxpayer would have direct access to the facts.

\textsuperscript{39} 410 U.S. at 450.

\textsuperscript{40} "The partnership earned the income and, as a result of arm's-length bargaining with Kaiser, was responsible for its diversion into the trust fund." \textit{Id}. at 451.

\textsuperscript{41} \textit{See} INT. REV. CODE of 1954, §§ 421-25.

\textsuperscript{42} \textit{See Id.}, § 72.

\textsuperscript{43} \textit{See Id.}, § 105.

\textsuperscript{44} \textit{See Id.}, § 79.
These programs are funded by employer contributions to an educational trust which is to be used to subsidize the college education of employees' children. The direct compensation of the employee is in no way affected by the number of children covered under the plan and supposedly "no employee has an option to receive anything of value in lieu of his child's eligibility under the Plan."45

At least one commentator has suggested that the concept of prior-bargaining—therefore-taxation is completely irrelevant to college benefit plans since the employer's trust contributions should not be characterized as compensation in the first place.46 Rather, they should be viewed merely as a "corporate program adopted primarily and as a matter of fact for the best business interests of an employer" which has the "incidental result of benefiting employees in noncompensatory ways."47 However, the courts are more likely to adopt the attitude that "[w]hen an individual is attracted to a job or motivated to remain in his job by the promise of certain fringe benefits, such benefits are prima facie compensatory."48 The Basye Court seems to have ratified this latter approach by refusing to even consider that the trust payments were anything but compensation for services performed by Permanente.49

In deciding whether college benefit plans result in currently taxable income, it is first necessary to determine as to whom these trust payments are "compensatory benefits." Certainly, any attempt to make such a determination before individual rights to the use of the funds have been exercised would have to be based on rather arbitrary criteria. Even if it could be determined that this type of plan is a compensatory benefit to a certain employee or group of employees, the use of Basye as a precedent is not without its problems. The argument in Basye was based on the assumption that Permanente did in fact bargain, as a matter of law, to accept the trust payments in lieu of more direct compensation.50 Such an assumption was probably justified in view of the facts involved in that case, but it may

46. Id.
47. Id. at 340.
49. See note 40 supra.
50. See note 32 supra.
not be appropriate in situations where the facts are not so compelling. Where top executives are involved, the assumption that they do in fact bargain for the method of compensation would seem to be at least a supportable position, and the resultant tax liability according to the assignment of income theories developed in *Basye* would not appear to be grossly unjustified. In the case of lower echelon employees whose bargaining power is admittedly diminished with respect to modes of compensation, the assumption of bargained-for compensation becomes less and less tenable.\(^5\) With respect to fringe benefit programs in which persons other than the employee himself are beneficiaries, the employer's payments should result in currently taxable income to the employee only in situations where it is evident that the employee has bargained for the establishment of a fringe benefit program with the intent to divert his compensation elsewhere.\(^6\)

**BASYE AS APPLIED TO DEFERRED COMPENSATION PLANS**

Although the issue in *Basye* was clearly one of assignment of income, it is possible that this case could also affect situations where it appears that a cash basis taxpayer would have received compensation currently if he had not decided to enter into an *unfunded* deferred payment contract. This situation traditionally involves a question of *when*\(^6\) the income is tax-

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\(^5\) For a more detailed discussion of this type of fringe benefit program with respect to its compensatory aspects, see Geske, *Scholarships for Dependents of Company Employees: Tax Problems of Company Foundations*, 51 *TAXES* 21 (1973).

\(^6\) It is interesting to note that Treas. Reg. § 1.117-3(a) (1960) provides that:

> If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

Although this type of arrangement could have been characterized as compensatory with respect to the parent-faculty member, under a strict application of the *quid pro quo* analysis (see note 48 *supra* and accompanying text) the Treasury has instead deemed it appropriate to classify the free tuition as a scholarship under *Int. Rev. Code* of 1954, § 117.

\(^6\) It is necessary to distinguish situations involving the question of *what* is income, which are controlled by the doctrine of "economic benefit" or "cash equivalence." This is usually not a problem with regard to *unfunded* deferred compensation contracts. *See Rev. Rul. 60-31*, 1960-1 *CUM. BULL.* 174, 177, which states:
able (constructive receipt) rather than a question of to whom it is taxable (assignment of income), but the courts have tended to integrate these two theories. Consequently, the distinction is often obscured in judicial opinions. Thus, it is quite possible that some courts will attempt to answer the question of when a taxpayer should be taxed on income earned under an unfunded deferred payment contract by using assignment of income theories developed in Basye, despite the apparent distinction between the two legal theories involved.

Deferred compensation plans can generally be separated into two major groupings: funded and unfunded. A funded plan requires that the employer currently set aside funds to meet his future obligations under the deferred payment arrangement. This is normally done by contributing to a trust or escrow fund that is later distributed to the employees according to the schedule incorporated into the plan. Since sections 401 through 404 of the Internal Revenue Code have already established a framework to control the taxation of such contributions, it is most unlikely that the ruling in Basye will have any significant effect on funded plans.

In the area of unfunded deferred compensation contracts, however, the standards of taxation dictated by the doctrine of constructive receipt are not nearly so well defined. The concept underlying this doctrine is basically one of control.

Treasury regulations provide that:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during

A mere promise to pay, not represented by notes or secured in any way is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method.


55. See 2 J. Mertens, LAW OF FEDERAL INCOME TAXATION § 10.01 (Rev. 1968):

[T]he theory of constructive receipt is properly applicable to those situations involving the question as to when income is received. . . . [The] latter cases [involving assignment of income] really seek a determination as to who is the taxpayer with respect to a particular item of income rather than when a particular item of income is to be reported by and taxed to the taxpayer.

56. A failure to recognize constructive receipt of income as income realized would open the door to avoidance and possible evasion. A taxpayer should not have the right to select the year in which to reduce income to possession. It is now well settled that income which is subject to a taxpayer's unfettered command and which he is free to enjoy at his own option is taxed to him whether he sees fit to enjoy it or not.

Id.
which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time
...

To the extent that Basye speaks to this type of control, the case may well be used as a precedent in the area of unfunded deferred compensation contracts. 58

In Basye, the Court held that Permanente had bargained for the trust agreement which required payments to be made directly to the trust. As a result, Permanente was held to have had sufficient control of the payments to require that they be reported as current income. 59 Although the Court did not explicitly evaluate the type of control required, it is clear from the opinion that something less than complete control was sufficient:

The Government need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received . . . . We think it clear . . . that the tax laws permit no such easy road to tax avoidance or deferment. 60

The apparent analogy to be drawn between Basye and the situation in which the taxpayer bargains for an unfunded deferred payment contract is deceivingly simple. Just as Permanente's bargaining for the method of its compensation was sufficient control to result in taxable income as payments were made to the trust, a taxpayer who bargains for the method of deferment or for the initiation of the deferment plan should also report such deferments as current income when they would have otherwise been received. A concern with the tax effect of having employees exercise control over the decision to defer their compensation is not foreign to this area of tax law. This was emphasized in one commentary as follows:

Taxpayers and their representatives often labored earnestly to demonstrate that the deferred pay arrangement served the needs of the employee . . . or that it was insisted on by the employer. 61

58. This would not be the first time that theories developed in anticipatory assignment law have been used to establish the control necessary to apply constructive receipt law. See Hicks v. United States, 314 F.2d 180, 183-84 (1963).
59. Permanente's agreement with Kaiser, whereby a portion of the partnership compensation was deflected to the retirement fund, is certainly within the ambit of Lucas v. Earl.
410 U.S. at 451.
60. Id. at 452.
At this point, several questions remain unanswered. The degree of control required before the doctrine of constructive receipt can be applied has not yet exactly been determined. The discussion in *Basye* concerning the tax effects of the taxpayer's bargaining for the contract that controls the method of compensation might seriously affect deferred compensation law. Finally, it remains to be seen whether any such effect is justified.

Before the doctrine of constructive receipt can be applied, it has always been required that the taxpayer's control of the income be subject to no substantial limitations.62 In a situation where the cash basis taxpayer contracts with his employer prior to performance to defer payment for services, there is apparently no basis for applying the constructive receipt doctrine.63 At the contract date, the income has not been earned; thus, the employee has no current right to receipt. When the income is earned, the right to receipt has already been postponed under the terms of the contract.

However, the degree of control the taxpayer may have in arranging such deferment contracts while still avoiding the application of constructive receipt remains uncertain. A number of cases have discussed in depth the importance of the taxpayer's involvement in the deferral arrangement and/or his intent to defer or avoid taxes.64 Although none of these cases found the extent of the taxpayer's involvement, in and of itself, a viable criterion on which to base the application of constructive receipt,65 they have precipitated a good deal of discussion concerning how much taxpayer control is permissible.66 In *Hicks v. United States*,67 the court ruled that the "power to dispose of

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62. Treas. Reg. § 1.451-2(a) (1964) provides:


64. See Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961); Drysdale v. Commissioner, 277 F.2d 413 (6th Cir. 1960); Williams v. United States, 219 F.2d 523 (5th Cir. 1955); Commissioner v. Oates, 207 F.2d 711 (7th Cir. 1953).

65. See, e.g., Dohan, supra note 63, at 518: "The Fifth Circuit, in reversing Cowden [289 F.2d 20 (5th Cir. 1961)] has held that the willingness and ability of the payor to pay is not to be considered, and that a tax avoidance motive should be a neutral factor."


67. 314 F.2d 180 (4th Cir. 1963). The taxpayer was given the op-
income as he wishes results in taxable income to the holder of
that power.68 This apparently established some outer limits
on the allowable taxpayer control over deferral arrangements,
but the case has little precedential value because of a subse-
quent Revenue Ruling69 which explicitly limited Hicks to its
quite distinctive facts. Also, in Commissioner v. Basila,70 the Tax
Court stated:

The argument that the principle of constructive receipt comes
into action with the mere possession of the power (as opposed
to the right) to receive funds extends the principle to unwar-
ranted limits and has been rejected by the courts on numerous
occasions.71

On this issue of permissible taxpayer control, the Treasury
takes the position that it will not administer the statute by
"speculating whether the payor would have been willing to
agree to an earlier payment."72 However, this same ruling
stated that "in each case involving a deferral of compensation
a determination of whether the doctrine of constructive receipt
is applicable must be made upon the basis of the specific factual
situation involved."73 This apparently left open the question
concerning the applicability of the constructive receipt doctrine
when it was clear beyond speculation that the taxpayer would
have received current compensation were it not for the de-
ferment contract.74 In 1965, however, in Robinson v. Commiss-
ioner,75 the importance of the taxpayer's power (as opposed to
right) to receive compensation sooner than contracted for under
an unfunded deferred payment contract was largely discredited
as an effective criterion governing the application of construc-
tive receipt.76 In this case, the deferred payment contract was

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68. Id. at 185.
70. 36 T.C. 111 (1961).
71. Id. at 117.
73. Id.
74. See Knight, supra note 66, at 171.
75. 44 T.C. 20 (1965).
76. It is important to note that the Government does not base
its constructive-receipt argument upon the fact that IBC
[payor] was willing to enter into a contract on July 31, 1957,
to make payments in full to petitioner immediately after the
Sept. 23, 1957, fight. Indeed the Government refers to example
(3) in Rev. Rul. 60-31, 1960-1 C.B. 174, implying that a bona
fide contract providing for deferred payments would be given
clearly entered into at the behest of the taxpayer; yet the Government failed to even argue that such control of the timing of compensation should result in constructive receipt. Thus, the logical conclusion is that a bona fide unfunded contract which is legally binding on the parties and provides for deferred payment will be given tax effect if entered into prior to the attainment of a "right" to receive income currently. This is true regardless of the purpose for such deferment and/or the existence of the apparent ability to receive that income at an earlier time.

Despite this prior authority, the Court in Basye quite clearly held that the partners could not defer receipt of income for tax purposes by contracting away in advance their right to receive direct payment. In reaching this conclusion, the Court stated that the Government need not prove complete control over the effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time.

Id. at 36. See also McDonald, Deferred Compensation: Conceptual Astigmatism, 24 Tax L. Rev. 201, 220 (1969).

To be sure, IBC probably would have been willing to pay over to petitioner the full amount due him in 1957. Robinson v. Commissioner, 44 T.C. 20, 37 (1965).

It is interesting to note that in the case of qualified pension and profit-sharing plans, the IRS has ruled several times that the mere power of a participant to make an election to defer payment of his share beyond the time that it would otherwise be payable does not result in the characterization of such payments as "made available" and hence taxable to him under constructive receipt law. See Rev. Rul. 57-260, 1957-1 Cum. Bull. 164; Rev. Rul. 55-423, 1955-1 Cum. Bull. 41.

The proper test would appear to be whether the arrangement was a valid one from the standpoint of a binding agreement and one court of appeals [5th Cir.] has flatly rejected the suggestions that there is any further "business purpose" gloss on the doctrine.

Knight, supra note 66, at 174.

Under the decided cases . . . and Revenue Ruling 60-31 and private rulings issued by the Service, an employee is, in general, allowed to elect deferment prior to the time he is entitled to be paid without adverse tax consequences.

McDonald, supra note 76, at 236.

On the other hand, it must be recognized that a taxpayer has a perfect legal right to stipulate that he is not to be paid until some subsequent year, or that the payments are to be spread out over a number of years. Where such a stipulation is entered into between buyer and seller prior to the time when the seller has acquired an absolute and unconditional right to receive payment, and where the stipulation amounts to a binding contract between the parties so that the buyer has a legal right to refuse payment except in accordance with the terms of the agreement, then the doctrine of constructive receipt does not apply, and the taxpayer is not required to report the income until the same is actually received by him.

manner in which income is to be received.\textsuperscript{83} Instead, the fact that the partners had bargained for the deferment was held to result in current taxability for that compensation.\textsuperscript{84} It must be remembered, however, that \textit{Basye} basically involved a question of who was the appropriate entity to report the income\textsuperscript{85} rather than when a given taxpayer was to be taxed on a particular item of compensation.\textsuperscript{86} In the typical anticipatory assignment of earned income case, the question of who is the proper taxpayer does not usually involve the question of control but instead deals with the simple factual question of whether a particular item is compensation to the taxpayer.\textsuperscript{87} If the compensation question is answered in the affirmative, the court need only invoke the well-established doctrine that the tax on compensation must be paid by the person who earns it.\textsuperscript{88} The discussion of the requisite control in \textit{Basye} was merely a response to the argument that the case fit within the ambit of the limited exception to the prohibition against assignment of compensation discussed earlier with respect to the \textit{First Security Bank} and \textit{Teschner} cases.\textsuperscript{89} Giving effect to \textit{Basye} within the area of unfunded deferred compensation contracts would be an inappropriate application of assignment of income law. Such an application would not only be in derogation of the established law in the area but would also threaten the integrity of the entire cash reporting system.

Unlike the typical assignment of compensation case where the assignor is attempting to use mere form to avoid the effects

\textsuperscript{83} 410 U.S. at 452.
\textsuperscript{84} See note 40 supra.
\textsuperscript{85} The entity earning the income . . . cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity. Such arrangements, known to the tax law as “anticipatory assignments of income,” have frequently been held ineffective as means of avoiding tax liability.
\textsuperscript{86} 410 U.S. at 449-50.
\textsuperscript{87} Although the issue of when the partners must report their respective shares of partnership income was involved in \textit{Basye}, it is controlled by Treas. Reg. § 1.702-1 (1968) which is completely outside the area of constructive receipt law.
\textsuperscript{88} See, e.g., note 75 supra and accompanying text; Commissioner v. Culbertson, 337 U.S. 733 (1949); Helvering v. Eubank, 311 U.S. 211 (1940); Burnet v. Leininger, 285 U.S. 136 (1932); Lucas v. Earl, 281 U.S. 111 (1930). \textit{See also} the earlier discussion of fringe benefit programs with respect to the application of assignment of income at text accompanying notes 40-52 supra, where the critical question was whether the benefit was compensatory.
\textsuperscript{88} See text accompanying notes 25-28 supra.
of the graduated tax system, the taxpayer who defers compensation under an unfunded deferred compensation contract is actually incurring a substantial disadvantage. Not only does he surrender his present right to use such funds, but he also runs the risk of not being able to collect from the employer when the compensation becomes payable. An even more important reason to resist the application of the Basye concept of prior-bargaining-therefore-taxation to constructive receipt law, however, is the need to preserve the integrity of the cash basis method of reporting income. Predicating the application of the constructive receipt doctrine on the fact that the taxpayer could have retained the right to receive income currently can only result in a judicial nightmare. The courts would find it difficult to produce consistent and just results since they would be forced to rely on inference and supposition.


91. It must be remembered that the concept under examination is the degree of control necessary to precipitate the application of the constructive receipt doctrine. Even if the unfunded promise of future payment were currently marketable and therefore taxable as "cash equivalence," this fact would have no bearing on the discussion of the existence or nonexistence of the necessary control. See note 53 supra. As pointed out in Cowden v. Commissioner, 289 F.2d 20, 23 (5th Cir. 1961), a clear distinction should be drawn between the effect of the obligor's willingness to make full payment at a date earlier than the contract date and the effect of the current marketability of the promise to pay a stipulated amount at a future date.