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Deferred Compensation and Other Fringe Benefits

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Deferred compensation in its broadest form may be said to be any type of payment, regardless of the form in which made, that is earned, at least conditionally, currently but is payable at a future date. The exact conditions of a particular plan are almost as varied as the number of companies that have them. The form of payment may likewise be variable as to form and time.

The objectives of the various types of plans will also vary within each company. There are, however, several underlying reasons that contribute to the type of plan adopted in almost every situation. The sharply graduated rates of tax applicable to individual incomes have made it extremely difficult for the employer to compensate his employees adequately, particularly those at the executive level. In order to provide adequate incentive for maximum effort it has, therefore, been necessary for the employer to attempt to devise means that will provide income to the employee either at the favored capital gains rates or at a later time when his rate of tax will be lower, or that will provide benefits that are not taxable at all.

Since most employees will also be interested in having an income after retirement, the employer must also consider plans that will give these benefits.

The primary objective of the employer will almost always be to retain the best possible personnel with the least possible turnover, and with the best possible safeguards for his trade secrets. In order to accomplish this, the employer may provide for future compensation that will be payable only in the event the employee remains with the company for a certain specified period and refrains from certain acts that the employer may consider as potentially harmful to his business.

Aside from accomplishing these employer objectives, the primary concern insofar as the employee is concerned is to make certain that the particular type of plan actually allows the employee to report for tax purposes at the subsequent date whatever benefit he derives; or in other language, there must be adequate safeguards against a contention that a payment is constructively received by the employee before the time actual payment is made. Certain types of these plans have now received favorable approval by Congress and the rules relating to them are embodied in the Code. The most common are pension plans, profit-sharing plans, and restricted stock-option plans.[1] Although these plans will be discussed a little later, time permitting, the more difficult areas of those not specifically covered by the Code will be considered now.

PROBLEM AREAS OF DEFERRED COMPENSATION PLANS

First, let us consider the simplest type of deferred compensation arrangement—that is the one where an employee agrees to work for a specified sum payable currently and with a specified sum payable at specified or determinable times in the future. It has generally been conceded, at least until recently, that in order to prevent constructive receipt, it was quite desirable to have the future payments made dependent on contingencies such as the employee's being available for consultation, refraining from competition, or remaining in this country. These arrangements have been the subject of much litigation and a review of a few of these will help in understanding the problem.

The *Oates* case,[2] which has now been acquiesced in by the Commissioner, concerned the payment of renewal premiums to retired insurance agents. Each agent after retirement was entitled to receive a payment on a yearly decreasing percentage from each renewal. Since payment to the agents on this basis caused the agents to make large tax payments in the early years of retirement, they negotiated with the company to pay them in equal monthly instalments over a period of not more than fifteen years but over such lesser period as the agent might elect. The company continued to credit the appropriate amount of each renewal to the account of the individual agent but paid the agent and charged his account only with the agreed monthly amount. In holding for the agents the court noted that the consideration for the new agreement was the extinguishment of the old agreement and that *realization of income is the taxable event rather than acquisition of the right to receive it.*

In another recent decision the Sixth Circuit has reversed the Tax Court and held for the taxpayer.[3] Drysdale had been a long-time employee of Briggs Manufacturing Company and in 1952 he entered into

[1] Internal Revenue Code Sections 401 and 421.
[2] *Commissioner* v. *Oates,* 207 F2d 711.
[3] *Drysdale* v. *Commissioner,* 277 F2d 413.

a contract with them whereby the company agreed to pay him $1,500 per month for ten years following the termination of his full-time activities. During this ten-year period Drysdale was to serve as advisor and consultant and was not to accept employment with or acquire an interest in any activity inconsistent with or adverse to the activities of Briggs. In 1953 Briggs sold its automotive and aircraft division to Chrysler Corporation and, therefore, desired to amend its contract with Drysdale. As a result of negotiations the contract was reduced to $90,000 payable over a five-year period. Briggs was to make payment of $1,500 per month to a trustee who would pay Drysdale or his estate. Drysdale was then permitted to accept employment with Chrysler Corporation, the purchaser. The court in holding for Drysdale stated that at no time did he have any right to the immediate possession or enjoyment of the benefits of the contract.

Although the Government has given notice that it will not appeal this case to the U. S. Supreme Court, an article in the *Journal of Taxation* for September 1960 suggests caution in accepting this case. The article states that counsel for Mr. Drysdale has indicated that the trust was forfeitable and that the trust arrangement was less favorable to the taxpayer than might be presumed from a reading of the Tax Court opinion. It is stated that payment by the trustee was contingent on the rendition of service by the taxpayer.

The contingency and forfeiture provisions of the trust would distinguish the *Drysdale* case from the *Sproull* case[4] in which it was held that the transfer of funds into a trust constituted taxable income at the time of the transfer.

Perhaps the most helpful recent event in this area was the issuance of a Revenue Ruling in April of this past year that gave five specific examples of deferred compensation situations and then analyzed each.[5] Although the ruling closes with the statement that no advance rulings will be issued in specific cases relating to deferred compensation arrangements, certainly arrangements that very closely follow the examples could be used with very little possibility of question by the Internal Revenue Service.

Although it does not seem desirable to review each of these examples in detail, I should like to mention some of the points raised in this ruling. It is pointed out that there is no income under the cash method of reporting merely because there is a promise to pay that

[4] *Sproull* v. *Commissioner*, 194 F2d 541.
[5] Rev. Rul. 60-31, 1960-1 C.B. 174.

is not supported by a note or secured in any other way. This is emphasized by a quote from the Board of Tax Appeals from the *Zittel* decision,[6] "Taxpayers on a receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more."

The ruling points out the requirements of the Regulations[7] that income is taxable when it is available to the taxpayer whether or not he actually receives it. It is also noted, however, that this provision cannot be interpreted to say that the parties to a contract would have been willing to make an agreement different from the one actually made.

The ruling conspicuously omits in at least two of the examples any mention of a contingency other than that inherently concerned with the ability of anyone to meet his contractual promises. As has been pointed out by one writer, it may still be desirable to include some of the contingencies that have been considered to be of importance in the past, as the courts have considered such contingencies of importance. Also the ruling specifically points out that each particular case must be judged on its own merits and that, as previously mentioned, no advance rulings will be made. Thus the Government need only distinguish the case from one of its examples and thereby rule adversely for the taxpayer.

The tax deduction for the employer in this type of deferred-compensation payment is at the time of payment to the employee. Thus, the employer is faced with a liability that is the result of current operations but for which payment will be made in the future. The prudent employer will, of course, desire to make some type of provision for this subsequent liability. This can be accomplished without income tax results, through the recording of an accounting reserve or it may be accomplished by means of life insurance. The *Casale* case[8] which was decided in 1957 illustrates the latter method.

In that case the corporation, of which Casale owned 98 per cent of the stock, agreed, on certain contingencies, to undertake payment of $500 per month for life to Casale on his reaching sixty-five years of age or certain payments to his nominees if he died. The corporation then took out $50,000 of life insurance on Casale with payments to be made directly to Casale after he reached sixty-five. The corporation,

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[6] *Zittel* v. *Commissioner,* 12 BTA 675.

[7] Regulations Section 1.451-2(a).

[8] *Casale* v. *Commissioner,* 247 F2d 440.

however, retained the right to assign the policy, change the beneficiary, receive any dividends, or borrow on the loan value. The court in holding that Casale did not receive income equivalent to the premiums paid stated that the taking out of the policy by the corporation merely indicated the method that had been chosen to fulfill its obligation. Payment to Casale was not unconditional as corporate insolvency would have terminated the taxpayer's interest in the policy. If Casale had died between the ninth and thirteenth year of the policy the corporation would have received more on the policy than its $50,000 liability to Casale. The court found that this transaction was not a sham.

This case shows that deferred compensation benefits can be available even in closely held corporations. It should be emphasized that such arrangements will undoubtedly be scrutinized more carefully by Internal Revenue Service than they would be in the publicly held company. The officer-stockholder of the closely held corporation must always be alert to the problem of setting his total compensation at an amount that will be considered reasonable in relation to the services he performs.

A minor variation of the plan is frequently used by the employer to try to keep his executive personnel. The employer awards a bonus to the individual employee at a given time but provides for payment to be made in two or more instalments provided the employee remains with the company until certain specified dates. Amounts are taxable to the employee and deductible by the employer when payment is made. Because of the limited time over which the payments are spread the employee usually does not receive any income tax advantage from this arrangement.

Another variation of this plan is to make awards for ideas, improvements, or particularly important and unusual service to the employer. This type of award may likewise be payable over two or more years. Since this type of award would not likely be made to one employee each year, the employee would probably receive a tax benefit by the instalment-payment method and the consequent lower tax rates.

Although there are a large number of additional arrangements that might be mentioned, they will all follow the same basic income tax pattern, and the variations will be only to accomplish the needs of a particular company or situation.

PLANS BASED ON MARKET VALUE OF STOCK

Perhaps one of the best measures of the competence and worth of executives of a company is the increase they are able to make in the assets of the company or in the market value of the capital stock. Thus it is normal that many plans are keyed to the value of the employer's stock. Some companies have provided *bargain purchase* stock plans for all of their employees. These usually do not meet the standards for restricted stock options. The amount that an individual employee is entitled to purchase is limited to a percentage of his salary. In the case of the executive, the amount of stock he can acquire by this method is limited. Also, any spread between the price paid for the stock and the fair market value is ordinary income and therefore the added compensation is subject to the same limitations as increasing his salary. Provided the stock is retained by the employee, the proprietary interest should increase his efforts for the company.

The more favorable arrangement is to grant the employee an option to acquire stock of the employer corporation for a fixed number of years in the future at today's market price or a fixed percentage thereof. Very briefly, there is a restricted stock option qualifying under section 421 of the Code if the option price to the employee is at least 85 per cent of the fair market value of the stock at the date of granting of the option. No income will be attributable to the exercise of the option by the employee nor will any deduction for compensation be allowed to the employer. This particular provision of the law is extremely useful in publicly held companies where there can be no question of the valuation of the stock. A serious limitation is imposed in the case of a closely held corporation, however, even though the option may be granted to one who holds no stock in the corporation. It is very difficult, if not impossible, to determine the fair market value of the particular stock. An ingenious devise had been used to circumvent this problem by providing that the option price shall be a certain amount or 85 per cent or such greater precentage as may be desired, of the market value as determined by the Commissioner on examination of the return. The Commissioner has now indicated that he will not accept this method of solving the fair-market-value question.[9]

A problem with any type of stock option is that the employee is required to have capital in order to avail himself of the benefits.

[9] Rev. Rul. 59-243, 1959-2 CB 123, and Rev. Rul. 60-242, 1960-2 CB 158.

In case a particular option fails to meet the tests of the restricted stock option either because of the fair-market-value test or for some other reason, the tax problem to the employee and employer are more complex. Since the *LoBue* case[10] was decided by the Supreme Court, it is no longer possible to grant a stock option that will be considered as primarily for the purpose of giving a proprietary interest in the business and thus not compensatory in nature. Amendments to the regulations dealing with the subject were proposed in December of 1960 and adopted on January 20 of this year.[11] These regulations represent the first time, officially at least, that the Internal Revenue Service has been willing to concede that the granting of the option might itself be the time for measuring and reporting any income. The Supreme Court in the *LoBue* case had indicated that this might be the appropriate rule.

The Treasury Department now states that if the option has a readily ascertainable fair market value, then the value of the option is ordinary income to the recipient on receipt of the option. This sounds very good until we come to the definition of an option with a readily ascertainable fair market value. It is stated that there is no such value unless the option is actively traded on an established market. In cases where there is no readily ascertainable fair market value, the employee receives compensation at the time he receives an unconditional right to receive the stock. Such right will not be considered as being acquired prior to the time the option is exercised. If the stock is restricted in such a way that there is a significant effect on its value, then no compensation is realized until the restrictions lapse or the employee disposes of his stock. The compensation is then the lesser of the difference between the fair market value of stock and the option price at the time of exercise of the option or the difference between the option price and the fair market value at the time the restrictions lapse or the stock is disposed of.

Note that this will permit the corporation to grant deferred compensation at or after retirement by placing restrictions on the stock that will prevent the realization of compensation at an earlier date.

Another variation of a plan in which compensation is based on stock value is to provide deferred credits to an employee based on the increases in stock values and dividends of the company over the term of his employment but payable after retirement or reduced ac-

[10] *Commissioner* v. *LoBue*, 76 S Ct 800.
[11] Regulations Section 1.421-6 and TIR 293.

tivity. The same rules would apply to this arrangement as to those plans providing cash compensation determined by other types of contract or formula. The liability of the company is quite difficult to determine in a given year and this offers a serious disadvantage to this plan.

FRINGE BENEFITS

Before considering the advantages of qualified plans, I should like to discuss certain of the fringe benefits that may be given to executives and other employees, with no income accruing to the employee but with a full deduction to the employer. The best known and most widely used of these benefits has been to provide group term life-insurance protection, group hospitalization insurance, and sickness and accident insurance. The furnishing of sizeable amounts of life insurance may be particularly desirable to the young executive who has children not yet capable of supporting themselves. Although the company may not be able to carry the insurance in its full amount after the employee has retired, it will provide benefits at the time the executive is most vulnerable. It should be emphasized that premiums paid by the employer on other than group term life insurance represents taxable income to the employee.

At least one variation has been devised to allow the employer to carry insurance only on the desired employees. This is the so-called split-dollar insurance. The employee pays the cost of pure insurance only, that is, the premiums less cash-surrender value and dividends. The employer is always entitled to receive the amount of cash-surrender value of the insurance policy. Although this provides a decreasing amount of insurance to the employee, it also provides it at a decreasing cost and probably provides coverage when it is needed most.

In spite of all the recent adverse publicity given to items that might be termed recreational or personal, it is still possible for the employer to provide executive dining rooms, country clubs, and many other benefits to each of the employees.

QUALIFIED PLANS

Although I realize that I have not covered anything like all of the various benefits that may be provided and perhaps have not covered one of your favorite plans, I should like to discuss generally the qualified plans. These are basically of two types—the pension plan and the profit-sharing plan.

While it is true that these plans must cover a large percentage of the employees and must be set up in such a manner as not to discriminate in favor of the executive or highly paid employees, it is nevertheless possible to base benefits on salaries that exceed the amount on which social security contributions are based and, therefore, have the executives get very material benefits. Qualified plans permit the employer to take a deduction at the time of his irrevocable contribution to the plan. No income accrues to the employees until he receives a distribution from the plan.

PENSION PLAN

The pension plan is designed to allow the employee to receive a certain sum per month after his retirement and proceeds are usually taxable as annuities. In fact many of the plans actually provide for the purchase of annuity contracts. Contributions to the plan must be within specified actuarial minimums and maximums.

PROFIT-SHARING PLAN

The profit-sharing plan on the other hand presents more flexibility in that it allows the employer to vary his contributions depending on his profits. Perhaps equally as important, funds may be invested in assets with a potentially higher yield without the risk of causing a larger employer contribution for subsequent periods.

One feature of the profit-sharing plan that has not been used frequently considering its many advantages is the contributory profit-sharing plan. In this case an employee makes a voluntary contribution of a specified portion of his salary, usually not in excess of 6 per cent although there also are said to be some that allow up to 10 per cent. The employer will then make a contribution to the plan in amounts based on the employee's contribution. The employee will receive a vesting in the employer's contributions after a certain period of time.

Two advantages are immediately apparent. First, the employee has the right to acquire additional funds from his employer. Secondly, the income from his own and the employee's contribution is not taxed to him until he receives it. For the highly compensated executive even the opportunity to receive income on his own savings without current taxation should be quite attractive. There are more advantages, however. Any lump-sum distribution made to the employee by reason of his retirement or complete separation from the service of the employer will be taxed to him at capital gains rates. There is a way, however, in which tax on a considerable portion may be postponed or in fact completely avoided. If all of the funds applicable to the employee are invested in stock of the employer corporation and the distribution to the employee consists of such stock, then any unrealized appreciation in these securities is not taxed to the recipient until he disposes of such securities.

CONCLUSION

This paper obviously does not cover the detail of any particular item that has been discussed. For the most part, it would be impractical to do so because of the needs of the particular plan. I hope, however, that the material presented has been sufficient to point out the possibilities and to promote the realization that some plan can probably be devised to meet the needs of almost any situation.