1969

How Uncle Sam helps business obtain top employees and keep them happy

Ronald W. Taryle

Recommended Citation

Tempo, Vol. 15, no. 1 (1969, March), p. 09-17

HOW UNCLE SAM HELPS BUSINESS OBTAIN TOP EMPLOYEES AND KEEP THEM HAPPY

by

RONALD W. TARYLE

There was a time when a company could reward a faithful employee or keep a valued executive happy by giving him an increase in salary.

But a handsome raise is now not always the way.

Today most of any normal salary increase is swallowed up in the higher taxes that must be turned over to the increased number of taxing authorities.

So to avoid this problem, companies have begun to turn to other methods of giving faithful employees financial rewards.

DEFERRED COMPENSATION

One of the first methods a company may turn to is deferred compensation. In its most basic form, deferred compensation is payment for current services which is not given to the employee when his services are rendered, but is paid later when the employee is in a lower tax bracket. This is usually after retirement.

If the deferred compensation plan is a qualified plan, as will be discussed later, the income is not taxable to the employee until the time he receives it, while the employer-company can take a deduction for the amount in the taxable year it is paid into a trust. Thus, the company's deduction can conceivably precede the employee's recognition of income by many years. Consequently, the employee is almost certainly better off and the employer is just as well off.

For certain non-qualified plans the company must defer its deduction for tax purposes until the time the employee recognizes the income. While the deferral is a tax disadvantage to the company, the company can use the cash for operating purposes since there is no requirement that the payments be funded in a trust.

In establishing a deferral of payment to the employee, the company must be careful to avoid the pitfall of "constructive receipt." This is a doctrine relied upon heavily by the Internal Revenue Service when income is credited to an employee without restrictions, or when a fund has been made available to an employee without substantial limitation or condition on his right to unfettered control of the fund. If the IRS is successful in contending that income has been constructively received by an employee, the amount would, of course, be taxable to him at that time. This would defeat the designed objective of deferring the actual payment. Therefore, the employee should not be permitted control when the payment is made. Complete control should remain with the employer.

QUALIFIED DEFERRED COMPENSATION PLANS

Simply stated, a qualified deferred compensation plan is one which takes advantage of the benefits offered because the plan comes within the realm of a particular code section bestowing such benefits. The plan can be a pension or retirement plan, a profit-sharing plan or a stock bonus plan. An employee's trust will not be exempt from taxation under Code Section 501 (a) and contributions made to the trust by the corporation will be denied a current deduction unless the trust is part of a plan that qualifies under Section 401 (a) of the Code. The one exception to this rule is a trust created or organized outside the United States. The intent of the provisions of Section 401 (a) is to preclude the particular plan from favoring those who would benefit most from having income deferred, such as executives and other highly paid employees, and to prevent the use of trust corpus or income for purposes other than the exclusive benefit of the employees.

To qualify for this preferential tax treatment, the plan must be reduced to a definite written program and communicated to the employee. In the absence of a communication, the position of the company would be in jeopardy if later challenged by the IRS on the ground that the coverage requirement had not been met. In addition, the plan must provide for funding through a domestic trust and, as mentioned, must be a plan for employees which is non-discriminatory in favor of a selective group.

It should be pointed out that there are many potential dangers revolving around the word "discriminatory." A plan may well be intended to provide the required coverage but could fall short. For example, the plan may cover all full-time salaried personnel; but if the only full-time salaried persons are shareholders, the classification would be deemed discriminatory. Further, if the age or seniority requirements or the employees' required contributions are set so high that they are inherently discriminatory in favor of the highly paid, the plan would not qualify.

It is also possible for a plan to qualify in one year but fail to qualify in its identical form in a subsequent year because of a change in circumstances. For example, assume a plan provides for coverage of all employees with tenure of five years.

If it develops that the turnover of employees in the lower income levels, which represent 50% of all employees, is 50% per year, it could be that the plan will not qualify. For this reason, it is highly recommended that the plan be reviewed periodically to insure that it continues to meet all requirements.

Since there are numerous ways in which a plan may fail to qualify, it is advisable for a company to obtain advance approval from the IRS before placing a plan into effect.

TAX EFFECTS OF QUALIFIED PLANS

The outstanding tax feature of all types of qualified plans enumerated in Section 401 is the current deduction allowed to the employer-company without the employees receiving the additional income. The limitation on the amount of the deduction to the company is dependent upon the type of plan.

With a profit-sharing or a stock bonus plan, the employer's deductible contribution is limited to 15% of the total compensation paid or accrued to covered employees.

For a pension plan, or an employees' annuity, the amount that can be deducted is determined actuarially but is generally limited to 5% of the total compensation paid or accrued to covered employees. However, it can be greater, and, in some cases, it can exceed the 15% limitation normally governing profit-sharing and stock bonus plans. In addition to these benefits, if the plan is funded through a qualified trust, the trust is exempt from federal income tax.

While the dual benefits to the employee and employer are perhaps the most significant attraction of the qualified plan, there are other features for the employee. One of these permits the employee or his estate to obtain favorable capital gain treatment if the total distributions payable to him under the qualified retirement plan are paid in one taxable year, either as the result of the employee's death or other separation from service or on account of his death after separation.

There has been much recent controversy over the interpretation of the phrase "separation from service" because of the rapid growth of corporate mergers and acquisitions.

One recent Tax Court case held that a reorganization must involve a substantial change in the make-up of employees, or there is no separation from service and hence no capital gain treatment. This case involved a "C" type reorganization (stock for assets) in which the profit-sharing plan was amended to give each employee the option of remaining in the plan or withdrawing from it and receiving a lump-sum distribution. The plaintiff, who continued in the employ of the new company, elected the latter alternative and reported the distribution as a long-term capital gain.

The Tax Court sustained the Commissioner's position that the amount was taxable as ordinary income. This indicated that a separation requires more than a continuation on the same job for a different employer, as a result of a reorganization or a liquidation.

It should be noted, however, that there have been several published rulings by the IRS to the effect that a reorganization accompanied by a termination of the company's pension or profit-sharing plan would give rise to capital gain treatment. It would appear that a change in the identity of the employer accomplished as part of a transfer of ownership, whether or not the transfer qualifies as a reorganization, cannot be a separation from service unless there is also a change in the make-up of the employee group.

Another important employee tax benefit occurs when a lump-sum distribution is made to the beneficiary of a deceased employee. If the distribution represents the employee's entire benefits and is payable in one taxable year, all money up to $5,000 qualifies as a payment subject to the death benefit exclusion with the taxable portion afforded capital gain treatment.

If instead of being paid in a lump sum, the distributions are paid during more than one year, they are taxable to the recipient in the year of receipt as an annuity. Also, if the payments are receivable by a beneficiary other than the employee's estate, the portion of the value receivable which is not attributable to the employee's contributions is excluded from his gross estate for Federal estate tax purposes.

One other tax advantage concerns stock bonus plans. It provides that if all the shares allocated to an employee are distributed to him by the trust in one tax year, he is taxed only on the amount the trust paid for the securities—and even then he is taxed at the favorable capital gain rates. The tax on the unrealized appreciation is postponed until the employee disposes of the stock.

Before leaving the area of qualified pension, profit-sharing and stock bonus plans, some mention should be given to plans covering self-employed individuals. The Self-Employed Individuals Tax Retirement Act of 1962, commonly called the Keogh Bill, permits all self-employed individuals to be covered by qualified plans just as employees are covered. Thus, self-employed persons are given the benefit of current tax deductions for contributions to a qualified plan.

Contributions in excess of the deductible limit, which is the lesser of $2,500 per year, or 10% of self-employment net earnings, may be advisable because the income generated will not be currently taxable and can be built up tax-free. This income is taxed to the self-employed individual or his beneficiary only when it is distributed or made available to him.

All full-time employees with three or more years of service must be covered by the plan, but it is not necessary that there be employees for a plan to be set up. Contributions for employees must be nonforfeitable when they are made. Unlike lump-sum distributions to corporate employees, such distributions to self-employed persons do not receive capital gain tax treatment. However, employees of self-employed persons do receive the capital gain tax benefit for lump-sum distributions.

As an offset to this detriment, the payments received by self-employed persons may enable them to avail themselves of the benefits of income averaging in the year of receipt.

TAX EFFECTS OF NONQUALIFIED DEFERRED COMPENSATION PLANS

Many laymen, and tax practitioners as well, are of the mistaken belief that a nonqualified deferred compensation plan is inherently bad—that a plan that does not qualify under Section 401(a) of the Code has built-in weaknesses which should be avoided. Indeed, the opposite may be true.

It is often highly impractical to provide attractive retirement benefits for key high-salaried personnel and still have the plan and related trust qualify for exemption as being nondiscriminatory. This is particularly a common problem for the small, closely held company desiring to bestow retirement benefits on its executives in varying degrees.

The dilemma can perhaps best be resolved by a nonqualified plan which should take the form of a mere contractual promise by the company to make payments at a future date. The company must be under no obligation to set aside a fund, from which to make future payments, in which the employee has either a forfeitable right or unrestricted right to currently receive distributions. If such a fund were created, the desired result would not be obtained. This is because, by making the employee's interest forfeitable, the company could never take a deduction, and if the employee's interest were not subject to restrictions, the employee would realize taxable income under the constructive receipt doctrine.

A deferral agreement of this type is valid and can be made to cover a number of executives or key employees. The employee, having no immediate right to receive any payments, is not taxed.

It is important to note that a lump-sum distribution to the employee or his beneficiary is not given the capital gain treatment that was available in the case of the distribution from an exempt trust. It should be clear that, in an arrangement of this nature, the company cannot take a deduction, a mere promise to pay at a future date, but it must postpone its deduction until the payment is actually made.

The mechanics of the nonexempt plan are simple enough. The amounts to be paid are generally predicated upon any of several factors such as a fixed total amount, a fixed amount per year of service, a percentage of salary or a percentage of sales or profits, etc. The payment of the benefits, as in qualified plans, usually begins at retirement and is either fixed or may take the form of an annuity. The mode of payment, while usually cash, may also be stock in the distributing company. This has a double advantage of conserving cash while, at the same time, giving the employee an ownership interest in the company.

While it was mentioned at the outset of this section that the employer could not set aside a fund in which the employee had either a forfeitable or a nonforfeitable interest, he may create a fund for his own benefit; but the plan should make no reference to it. Such a fund would be necessary, for example, when the employer's commitment could not be reasonably carried out without a fund such as a commitment to an annuity for life.

A common type of nonexempt plan provides for diversion of the net cost of an executive salary increase to the purchase of an endowment payable at age 65. The policy insures the executive but is payable to the company. Following the executive's retirement, the company agrees to pay him an annuity for life or a set term.

To avoid the application of the constructive receipts doctrine, payments would begin only when the first of the executives reaches retirement age, terminates his employment (including death), or suffers total disability. It is also common for a company to provide for certain conditions to control the executive after he leaves the firm. Breach of those conditions would result in forfeiture of the executive's rights under the plan.

Application of the doctrine of constructive receipt to certain deferred compensation arrangements was laid down by the Treasury Department in a 1960 ruling. To insure tax deferral, all nonexempt plans should comply with the governing principles set forth in this ruling. The five examples enumerated in the ruling can be summarized by stating that if the employee receives any immediate benefits or rights, which can be in the nature of a trust or escrow deposit made on his behalf, he will be currently taxed on the amount so deposited. It is interesting to note, however, that in at least one case the Tax Court rejected the government's position in one of the five examples.

THE NONQUALIFIED RESTRICTED STOCK BONUS PLAN

A private ruling was issued by the IRS in August 1967, regarding a restricted stock bonus plan. Since that time, considerable attention has been focused upon the benefits it confers.

A restricted stock bonus plan is an arrangement whereby an executive is given a bonus of company stock containing restrictions that have a significant effect on the market value of the stock. The advantages to the employee include a share in the company's growth and deferral of taxable compensation until the restrictions lapse or the stock is sold or exchanged in an arm's length transaction, whichever occurs earlier.

At the time the restrictions lapse, the amount of compensation includable in the employee's income is the lesser of the market value at the time the stock bonus was granted (determined without regard to the restrictions) or the fair market value on the date the restrictions lapse or the consideration received upon the sale or exchange, whichever is applicable. During the restriction period the employee is entitled to all of the other rights of ownership, such as the right to vote the stock or to receive cash dividends.

The restrictions may be lifted in installments to permit spreading of income over a number of years, but the company must be careful that the employee cannot prematurely cause the restrictions to be lifted by reason other than his termination of employment.

A recent revenue ruling (68-473, I. R. B.) illustrates one manner by which the lapsing of restrictions may be accelerated. In 1965 an employee of a corporation was given restricted stock as part of his compensation. The restrictions were to lapse at various intervals beginning in 1975. Early in 1968 the company was merged into another corporation in an "A" type reorganization. Pursuant to the plan of reorganization each share of the stock of the merged company, including, of course, the restricted stock, was exchanged for an equal number of unrestricted shares in the surviving company. The ruling held that the restrictions terminated and compensation was realized when the shares were exchanged for the unrestricted shares in the arm's length transaction that occurred.

While this ruling did not concern itself with the situation in which the new stock received was also subject to restrictions, it would appear that such an exchange would not trigger compensation. However, such a conclusion is not manifested by either the present or proposed regulations.

Under the present regulations, the value included as compensation becomes the basis for computing capital gain if the employee later disposes of the stock. Appreciation in value over the years, therefore, constitutes capital gain and the holding period begins with the date of issuance.

The employer must defer taking a deduction on the award stock until the employee recognizes taxable income. The deduction, at that time, would be equal to the amount the employee recognizes as income. Because the income recognized by the employee is subject to the withholding provisions of the Internal Revenue Code, the employer would be obliged to withhold applicable federal income tax. One potential manner in which this could be accomplished, and afford protection to the employer, would be for the employer to place in escrow a portion of the stock equal to the applicable withholding rate of each employee involved. The escrowed stock could be sold, if necessary, to provide the employer with the tax required for his deposit.

The probability that these plans will continue to confer the attractive compensation benefits on corporate executives has been greatly reduced by recent IRS action. The service proposes to amend its regulations to eliminate one of the outstanding features of the plans—the capital gain potential during the period of restriction. Under the proposals the employee would be taxed at ordinary income rates on the entire value of the stock at the time the restrictions lapse.

Public hearings on the proposed regulations were held on December 3, 1968, with 26 witnesses testifying against the proposals. Originally the amendments, if adopted in their present state, would have applied to transfers of restricted stock and to options for such stock granted after October 26, 1968; in view of the controversy that they stimulated, the IRS has recently extended the original effective date to June 30, 1969. This will provide additional time to evaluate the various suggestions stemming from the proposed changes. Therefore, prompt action is vital to obtain the benefits of a restricted stock plan. The service has indicated that no rulings will be issued involving transfers of stock having no readily ascertainable value while the proposals are pending.

There are other distinguishing features of a plan of this type. Because the plan is nonqualified the company can designate which employees will be participants. There is no concern over the discrimination prohibition of the qualified plans. However, the IRS has ruled that, if an employee under the plan can decide to take all or part of his bonus in stock, he must make his choice before any portion of the bonus is earned. This Internal Revenue position precludes the company from waiting until the end of the year to designate the participating employees and also precludes an employee from making a selection after he knows the amount of his bonus. These problems do not exist when the employee has no choice about receiving the stock.

From a financial statement standpoint, the issuance of restricted stock gives rise to a timing difference; that is, a difference between the period in which the transaction affects taxable income and the period in which it enters into the determination of pretax accounting income. Since the issuance of the restricted stock does not, of itself, create an immediate deduction for tax purposes, as previously discussed, an appropriate prepaid tax should be set up on the financial statements. The amount of the prepaid tax is the tax attributable to the value of the stock when issued.

In the year the restrictions lapse, a deduction for tax purposes will be allowed and the prepaid tax of the earlier year will be eliminated. Any difference between the initial accounting deduction and the final tax deduction will be accounted for in the financial statements in the year in which the tax deduction occurs.

STOCK OPTION PLANS AND THEIR ROLE IN COMPENSATION DEFERRAL

A stock option plan is a contract between the employer and the employee by which the latter receives the right to buy stock at a specified price and within a given period of time. The advantages to the employee are much the same as those he receives under the restricted stock bonus plan: namely he receives a proprietary interest in the company and obtains capital gain rates on the appreciation in value of the stock over the option price. For the employer, the principal advantage lies in compensating the employee without depleting the cash position of the company.

Stock options are either statutory or nonstatutory. Statutory stock options lost much of their glamour in the Revenue Act of 1964; however, even with stricter controls, they continue to have wide appeal because the executive can still obtain the much sought capital gain if he complies with the rules. And there is no requirement that the executive exercise the option, with its resultant cash outlay, unless he desires to do so.

Statutory stock options granted prior to 1964, referred to as restricted stock options, continue to have importance in that they are still subject to the old rules (those in effect prior to the Revenue Act of 1964). The old rules also apply to post-1964 options granted under a binding written contract entered into before 1964. Options granted after 1963 are referred to as qualified stock options. These options are subject to the new rules advanced by the Revenue Act of 1964. However, whether the options come under the old or the new rules, they can provide valuable incentives to employees. This is because no income is taxable to the employee until he disposes of the stock he received through exercise of the option.

The amount of income that is taxable to the employee as compensation depends upon how long he holds the stock prior to its disposition. This is the first major crackdown in the new law. Now, the employee must hold the stock for three years to take advantage of capital gain benefits for the entire excess of sales price over option price. The old law required a holding period of two years after date of grant and six months after date of exercise.

However, even if the stock is sold within the three-year period (but after six months), the employee's ordinary income from compensation is limited to the excess of the fair market value at the date of exercise over the option price. The balance of gain is capital gain. The company can, at that time, take a deduction for the amount of the employee's gain deemed to be compensation.

The second impact of the new law requires the employee to be employed continuously from the grant date to three months prior to exercise. Under the old law, the employee merely had to be employed on these two dates but there was no requirement of continuous employment. This has the effect of making the benefits of the plan available only to *regular* employees.

Third, the new law added a provision requiring adoption of a plan and the granting of the options pursuant thereto within 10 years from the earlier of the adoption of the plan or the approval of the plan by the shareholders. Further, the shareholders must approve of the plan within 12 months before or after it is adopted.

A fourth tightening of the old law requires that the option must be exercised, if at all, within five years of the grant date, as opposed to the 10 years allowed under the former law.

Fifth, the option price cannot be less than the fair market value at the grant date. The old rule required that the option price be 85%-95% of fair market value. If the fair market value is underestimated, even though a good faith attempt was made to value it at market, a limited tax is imposed at the time of exercise.

A final major change requires that the employee, immediately after receipt of the option, not own directly or indirectly more than 5% of the company's stock, measured either by voting power or value (10% is permitted for certain small corporations). Under the old law, the employee could be a 10% shareholder, subject to certain qualifications. Caution must be exercised in this regard and in those cases where the company has adopted a restricted stock bonus plan. The stock received by an employee under such a plan could put him over the limitation and the advantages of the stock option plan would, to a great extent, be dissipated.

Another type of statutory option is the employee stock purchase plan under Section 423. These options, granted after 1963, generally follow the rules relating to the pre-1964 restricted stock options with some modification and one major exception—the plan must not discriminate in favor of selective personnel. However, if desired, officers, highly compensated persons and persons who are employed less than two years may be excluded. The plan is limited to employees holding no more than 5% of the company's stock.

Before a company decides to provide employee benefits via the qualified stock option plan, careful consideration should be given to the advantages and disadvantages of such a plan as opposed to the other types of deferred compensation arrangements. In light of these, the company should decide on the plan best tailored to its needs.

The principal differences are:

- The employer obtains a deduction for deferred compensation when it is paid or funded, but no deduction is permitted under a qualified stock option for the spread between the option price and the value of the stock at the time of exercise unless the value of the stock exceeds the option price at the date of grant. However, this apparent disadvantage of the qualified stock option is at least partially offset by the fact that the company can conserve its working capital.
- Deferred compensation can be measured and controlled, whereas the amount of compensation involved under a qualified stock option plan is uncertain until the ultimate disposition of the stock by the employee. From the employee's point of view, the deferred compensation is more assured and definite in amount.
- Deferred compensation bears a relationship to the accomplishments of the employee, whereas ultimate benefits under a qualified stock options plan are predicated largely on the employee's judgment and the fluctuations of the stock market, and only indirectly on his efforts.
- Under a qualified stock option plan there is a dilution of shareholder's equity.
- No capital outlay is required of an employee under a deferred compensation plan in contrast to a qualified stock option plan.
- Deferred compensation is usually taxed as ordinary income, whereas there are opportunities of capital gain benefits under a qualified stock option plan.

The nonstatutory stock option plan, as the name implies, is any stock option which does not meet specific statutory requirements. The essential difference between this type of option and statutory options lies in the special tax treatment accorded the statutory option. This provides that compensation not be paid the optionee until he disposes of the stock received pursuant to the exercise of the option.

The history of nonstatutory stock options up to 1945 was one in which the IRS attempted to distinguish between options which were primarily compensatory in nature and those which were intended to give the employee a proprietary interest in his employer's business. The latter type was not taxed as compensation at any stage of the transaction—grant, exercise or disposition.

Between 1945 and 1950 the IRS decided that all bargain transfers of property were compensatory in nature and attempted to tax them in full as ordinary income. However, the courts, to a great extent, did not go along with this and continued to make the former distinction. This impasse continued until 1956 when the Supreme Court ruled that all nonstatutory stock options were compensatory in nature and normally resulted in taxable compensation upon exercise. The Court did not preclude the possibility that, in some instances, the employee would receive compensation upon grant of the option.

While this decision erased much of the widespread acclaim that had accompanied these options, increased efforts were made to capitalize upon those instances in which compensation would be received upon grant of the option. This is the ideal situation because compensation is measured by the spread between the option price and the fair market value on the date the employee has the unconditional right to receive the stock subject to the option.

In the majority of cases this spread will be narrowest at the time the option is granted. However, it is recognized that occasionally the fair market value at grant date may be higher than the fair market value on the date of exercise. In this event the employee will recoup at least part of the additional compensation upon ultimate disposition of the stock via a smaller capital gain.

Since there is normally no realistic basis for determining compensation when an option is granted because the employee may not exercise the option, the Commissioner and the courts agreed that there must be a readily ascertainable market value for the option if it is to be taxed when received. A leading Court of Appeals case held that if it appears that the option itself, rather than the potential profit resulting from the bargain price, was intended as compensation, the employee may include in income in the year the option is granted the amount the option exceeds what he paid for it.

The Court also emphasized that freedom of transfer of the option is a necessary element in determining its value.

The Commissioner, in an effort to thwart the substantial tax savings inherent in those situations in which the option is taxed when granted, has set up obstacles to hinder the determination of market value. If the option is not regularly traded on an established market, it must be freely transferable; it must be exercisable in full immediately; the related stock must not contain any restrictions affecting its market value; and the option privilege must have a readily ascertainable fair market value. The option privilege is the opportunity to benefit—without risking capital—at any time during the period the option is exercisable from any appreciation in the value of the property subject to the option.

The Commissioner apparently is implying that there are certain inalienable rights attached to an option which enhance its value. To what extent the courts will impose these obstacles is not certain; therefore, the future of benefits under nonstatutory stock options remains cloudy.

FRINGE BENEFITS IN LIEU OF COMPENSATION

While fringe benefits are not deferred compensation arrangements, they still deserve a place in this discussion since they bestow present benefits upon an employee without a corresponding tax cost to him at any time. Instead of increasing salaries enough for the employee to obtain fringe benefits for himself which must be net of the tax thereon, the company, by furnishing these incentives directly, can usually obtain large cash savings through favorable group rates often available.

To this is added the intangible feature of bolstering employee morale. Some of the more common areas to be considered are:

• Reimbursement of employee expenses such as those incurred for travel and entertainment. While the IRS has in recent years scrutinized company paid trips, lodges, boats, and the like, the company can fully reimburse its employees for actual expenses incurred in business travel. This can give an employee a vacation at a reduced cost if it is taken in conjunction with a valid business trip. If the trip is outside the United States, travel expenses, including meals and lodging, must be divided between business and pleasure. However, an allocation is not required if the trip is for one week or less or if the personal or pleasure portion is less than 25% of the total time away from home.

• Group term life insurance premiums for up to $50,000 are tax exempt to the employee and deductible by the company. If the coverage is greater than $50,000, only the excess "cost" of the additional protection is included in the employee's taxable income.
• Group health insurance premiums are tax exempt to the employee and deductible by the company.
• Low cost vacation programs can be offered on special rates given large organizations by travel agencies.
• Membership in or use of company-owned clubs can be made available.
• Medical check-ups at company expense can be provided. In addition, the company can adopt a medical plan, which can be discriminatory in nature, that allows non-taxable reimbursement for medical expenses incurred by the employee and his immediate family.

However, two recent Tax Court cases illustrate that the Government's increased discontent with medical reimbursement plans has met with some success and serve as a warning to would-be benefactors under these plans.

The first case, *Larkin,* involved a corporate employer who had a plan providing for medical reimbursements to its employees; but the payments were subject to the discretion of the officers and were, with one exception, made only to officers. The Tax Court held that the plan was not a "plan for employees" since the primary benefits were actually paid to employees in their capacity as stockholders, rather than in their capacity as employees.

The second decision involved a family corporation in which the father and three sons were officer-stockholders and the only persons benefited under the company's medical plan. The Tax Court disallowed the deduction of one son on the grounds that the payments made to him were in excess of reasonable compensation for actual services rendered.

While there is a question regarding the propriety of the Tax Courts' disallowance of the payments in the latter case, it is advisable for a corporation adopting a medical plan to structure it to come within the realm of the recent *Bogene* case. That case provides guidelines for formulating a plan in favor of stockholder-employees and without losing the deduction at the corporate level or having the benefits taxed as dividends at the shareholder level.

In *Bogene,* the corporation, which employs 50 people, adopted a plan providing that all medical expenses of its two officer-stockholders and their dependents were to be paid by the company. The Tax Court, in upholding the plan, distinguished between the *Larkin* case indicating that the *Bogene* plan was specific both as to coverage and the benefits payable. Thus, the Court recognized in *Bogene* that discrimination as to coverage can exist—a philosophy which is supported by the regulation which indicates that a medical payment plan may benefit one or more employees.

It would appear that a medical plan would be assured of qualification if it is formal and specific as to coverage and if the benefits conferred are defined and not left to an arbitrary determination.
• Holiday gifts of nominal value can be made to employees. However, if the gift is an item readily convertible into cash, it will be treated as compensation.
• Company-owned cars can be provided for designated employees. An employee receiving this benefit would be required to reimburse the company for use of the car not related to business. If, however, the business use exceeds 50%, a strong position could be maintained that, since depreciation, a major expense, is a function of the business use only, a considerably smaller per mile rate is applicable to the personal use, hence reimbursable to the company.
• Interest-free loans may be made to executives to cover large imminent expenditures. However, if the executive is also a major shareholder, the company must exercise care to arrange the transaction on a bona fide loan basis (including a provision for interest) to preclude the IRS from treating the payment as a taxable dividend. In a similar vein, there appears to be nothing that would preclude a corporation from extending its high credit rating to key executives who desire to consummate substantial investment transactions but lack sufficient personal resources to obtain the necessary financing. It is not believed that a plan of this type has been tested by ruling or court decision. Consequently adventurous taxpayers should prepare themselves for a challenge by the Government.

Because the competitive bidding of companies is high and will go higher in an effort to land the short supply of outstanding top level personnel, it is almost certain that the company that offers the most attractive package of current after-tax dollars and maximum post-retirement benefits will prevail.

In many instances, it is likely that the executive lacks the necessary control over company transactions to take full advantage of all possible tax saving devices. However, with adequate knowledge of the major available alternatives, he is well on the way to gaining the upper hand on his competitors by securing the best employees through effective tax planning.