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TAXING CORPORATE BONUSES AND "GIFTS"

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INTRODUCTION

The topic of this paper is one of the narrowest but most fascinating issues within the ambit of federal income taxation. I shall discuss the treatment for income tax purposes of payments by a corporation to an officer or employee, or to the widow or dependent of such officer or employee. The payment in question is voluntary in the sense that it is not made in pursuance of an expressed or implied contract between the corporation and the recipient.

The primary income tax issue to the recipient is whether the payment constitutes a gift within the meaning of the section of the Internal Revenue Code which excludes gifts from taxable income.¹ To the corporation, the question is whether the payment constitutes an ordinary and necessary business expense, deductible as such by the corporation from its income in computing its taxable income.² The payment will not qualify as a deductible expense if it falls into one of the following three categories: a true gift; a capital expenditure, *i.e.*, an outlay for good will; or a distribution of a dividend or assets to a recipient who is a stockholder.

A study of the cases reveals two fact situations which typically raise the problem of the classification for tax purposes of voluntary

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¹ All citations are to the Internal Revenue Code of 1954 unless otherwise indicated. Int. Rev. Code, § 102. This exemption, though contained in the invalid income taxing act of 1894, originated in the Revenue Act of 1913, ch. 16 §. III, 38 Stat. 166 (1913), and has been continuously in effect for all subsequent years.

² Int. Rev. Code, § 162. A similar provision was included in the corporation excise taxing act of 1909, ch. 6 § 38, 36 Stat. 112 (1909), which measured the tax by net income and has been in effect for all years of general income taxation.

payments by corporations. In the first instance, the corporation makes a voluntary payment to an officer or an employee, or to a retiring officer or employee. The resolution authorizing the payment is in words, perhaps sometimes in weasel words, which technically permit the recipient to maintain that the payment is a gratuity or gift, in which case the corporation may or may not claim a deduction. Often, the relationship of the recipient to the corporation—for example, where the payment is to one who is also a dominant stockholder or where the payment is made to officers in proportion to their stockholdings—will control the issues involved in a particular case.

In the second situation, either upon the death of an officer or employee, but, more frequently, upon the death of an officer, the corporation votes to pay the widow a lump-sum or to make certain periodic payments to her, such as, an amount equal to the monthly salary of her husband for a specified period. Here, too, there may be varying circumstances that preclude the application of one rule in all cases.

In a broader sense, I propose to do more than discuss the issues raised in these cases, and will study the problems in the light of the relation of the law of income taxation to private law, particularly commercial law. It is well to point out that the law involved in income taxation is not separate and distinct from other fields. Income taxation is parasitical; it depends for its facts upon private law, and, in cases such as these, involving the rights and relations of corporations to their stockholders and to other persons, particularly upon commercial law.

More specifically, the relation of commercial law to this discussion may be briefly explained in this way. The law of the state in which a corporation is formed is controlling in construing the corporate powers. In addition, the rights of a business corporation and its relations to others are determined by the applicable state law. True, if in a special case applicable state law differs from the law that generally prevails throughout the states, a given organization³ or transaction⁴ may be classified for income tax purposes according to the law that applies more generally among the states. This is essential in federal taxation, in order to meet the constitutional requirement of nationwide uniformity.⁵

³ See *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925), holding an organization to be an association taxable as a corporation, though by the applicable state law it constituted a partnership.

⁴ See *Burnet v. Harmel*, 287 U.S. 103 (1932), holding a transaction to be an oil and gas lease, though under the law of the state it was regarded as a present sale of the oil and gas in place.

⁵ In what I have said, it is implicit that, contrary to popular assumption, the functions of the tax lawyer and the commercial lawyer or general practitioner may

EMPLOYEE'S PENSIONS: A DEFINITION

To trace the growth and the confusion that has ensued in the treatment of voluntary payments by a corporation to officers, employees, and others, we need to go back to the beginning, to the corporation excise taxing act of 1909, which, though imposing an excise tax on doing business in corporate form, measured the tax by net income.⁶ At that time, the United States was a predominantly rural nation. In the main, its laws reflected the lives of rural men. In other words, Government had not yet developed the social and economic goals of today, nor had business adopted its present attitude toward its employees.

When men spoke of a corporation paying an employee a pension, the word "pension" suggested a matter of grace and not of right.⁷ "Pension" and "compensation" were not regarded as being synonymous terms.⁸ "Pension" ordinarily suggests the idea of a bounty⁹ or of a reward for service rendered, but it may include a grant which is a mere gratuity.¹⁰ In fact, even today the dictionary definition indicates that the primary attribute of a pension is that it is paid as a subsidy or a gratuity.

Thus, when we see that the Government first took the position¹¹ under the corporation excise tax act of 1909 that pensions paid or gifts made by a corporation to employees are gratuities and not ordinary and necessary expenses deductible by the corporation, we should not be greatly disturbed. Given both the meaning of that statute, and a 1910 Government ruling in which the words "pensions" and "gifts" were similarly classified as gratuities, it is clear that to the tax authorities, a pension was a gift and not a deductible business expense.

A year later, however, this definition no longer prevailed. In a ruling promulgated in 1911, the word "pension" was used in contradistinction to "gifts or gratuities."

overlap. This being so, it is in a sense unfortunate that tax specialists have pre-empted such a large place in the practice and administration of the tax laws. The lawyers who specialize in federal income tax law, although their contributions have been notable indeed, constitute the world's largest tax bar; for our guidance they have developed the world's largest body of judicial opinion respecting income taxation. Even so, there are signs of inevitable change. Though it is quite unlikely that the need for tax specialists will disappear in the foreseeable future, the non-tax lawyer is becoming increasingly more anxious to acquire expertise in the tax field, for fear of unwittingly creating tax problems that his clients would perhaps not otherwise have.

⁶ Ch. 6 § 38, 36 Stat. 112 (1909).

⁷ *Gleason v. Board of Comm'rs*, 92 Kan. 632, 635, 141 Pac. 584, 585 (1914).

⁸ This definition of "pension" may still be found today. See *DeWitt v. Richmond County*, 192 Ga. 770, 16 S.E.2d 579 (1941).

⁹ *Frisbe v. United States*, 157 U.S. 160 (1895).

¹⁰ *In re Opinion of the Justices*, 88 N.H. 511, 192 Atl. 494 (1937).

¹¹ T.D. 1606, 13 Treas. Dec. Int. Rev. 39 (1910).

Amounts paid for pensions to retired employees, or to their families or others dependent upon them . . . are proper deductions as "ordinary and necessary expenses"; gifts or gratuities to employees in the service of a corporation are not properly deductible in ascertaining net income.¹²

The rule as thus stated was carried forward and included in the regulations¹³ under the Revenue Act of 1913, which act was the beginning of our present general income tax system. Since the Act of 1913 was a general income taxing act, taxing individuals as well as corporations but expressly exempting gifts from the tax, the effect of this definition of a pension was not only to deny a deduction to the corporation, but also to relieve the recipient of a tax upon all amounts that were determined to be gifts.

This rule is a valid one, providing, however, that it is clearly established that the payment in question is really a gift. For reasons which shall be explained below, this writer seriously questions whether any business corporation may make a valid gift.

There is, however, no particular need to pursue this issue as it relates to pensions. The pensions now paid by business corporations are, as a general rule, paid pursuant to established retirement and annuity plans. These plans are a part of the regular plan of hiring and paying the employees. The employer's contributions to the pension are deductible and the benefits received by the employees on account of the employer's contribution are taxable to the employees.

INCOMPETENCY OF CORPORATION TO MAKE A GIFT

From the beginning, the corporation's legal competency to make a gift has been ignored in income tax litigation. More clearly, the issue of incompetency has rarely been raised; hence, there have been few occasions on which the courts have been called upon to decide whether an incompetent may have an intent to make a gift. In an early case¹⁴ before the United States Board of Tax Appeals, in which the Board held that there was a gift by a corporation to its vice president and general manager, the Board stated that the essential elements of a gift are an intention to give, a transfer of title or delivery, and an acceptance by the donee. Note that the Board did not mention the

¹² T.D. 1742, 14 Treas. Dec. Int. Rev. 123, 128-29 (1911). See T.D. 1675, 14 Treas. Dec. Int. Rev. 16 (1911) for a similar holding.

¹³ Treas. Reg. 33, Art. 120 (1913).

¹⁴ Appeal of Estate of David R. Daly, 3 B.T.A. 1042 (1926). But see *Weil v. Commissioner*, 31 B.T.A. 899, *infra* note 15, in which the Board stated that competency of the donor is one prerequisite. In the majority of cases, however, the issue of donative competency has not been discussed. See Appeal of E. B. Touser, 1 B.T.A. 1164 (1925); Appeal of John H. Parrott, 1 B.T.A. 1 (1924).

first prerequisite of a gift, namely, the competency of the alleged donor to make a gift.

Clearly, for there to be a gift, the donor must be competent to make one.¹⁵ But in the absence of statutory or charter authority to give away its assets, it is the thesis of this paper that a business corporation is incompetent to make a gift.

Though theoretically a state may, by statute, allow a business corporation to make gifts, as a practical matter it is not feasible to so permit, for such authority would impair the credit of the corporation. Money could not safely be lent to a corporation, nor could investors afford to contribute capital to it, unless the corporation agreed not to give away its assets.

This argument was apparently recognized when the modern business corporation laws were adopted. Even the New York Business Corporation Law as enacted in 1961, effective April 1, 1963, which goes perhaps as far as that of any other state toward allowing a corporation to do what an individual may do, does not expressly permit gifts other than for charitable purposes. It provides that each business corporation shall have power "*in furtherance of its purposes*"—

(12) To make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.¹⁶ (Emphasis supplied.)

Thus, by statute, this power is to be exercised only in furtherance of the corporate purpose. The following example will illustrate the significance of this limitation. A corporation engaged in a retail business in Watertown, New York, could properly contribute to the community chest of that city, but the New York statute clearly does not permit a lawful contribution to be made by that corporation to the community chest of Walla Walla, Washington. In short, there are two limitations in this statute. The act seemingly goes no further than to permit a charitable contribution which is made for a good business reason (the kind of a charitable contribution which has been held to be a deductible business expense), and which, except for a statutory

¹⁵ *Weil v. Commissioner*, supra note 14; 38 C.J.S. Gifts § 13 (1943).

¹⁶ N.Y. Business Corp. Law § 202.

Statutes expressly authorizing a business corporation to make donations to charity have been enacted in more than thirty states, including, among others, Illinois, California, Delaware, Massachusetts, New Hampshire, New Jersey, Nevada, Pennsylvania, Texas, Washington, West Virginia, and Wisconsin.

limitation,¹⁷ would be deductible in full in computing the corporation's taxable income.

Since a business corporation may lawfully devote its efforts only to furthering its business purpose, *i.e.*, the transaction of business for a pecuniary profit, it is implicit in the nature of a gift that the giving away of corporate property would not further the corporate business purpose. This is because a gift is commonly defined, even in federal tax cases, as a voluntary transfer of property without any consideration or compensation therefor.¹⁸ This concept of a gift has been inherited from the common law.¹⁹ As a practical matter the general rule may be thus stated: "[A] gift of property by a corporation not created for charitable purposes is in violation of the rights of its stockholders and is *ultra vires*, however worthy of encouragement or aid the object of the gift may be."²⁰

State cases show that there may be some question whether a corporate resolution to make a gift is void or voidable. Whichever it may be, however, the decisions are clear that where the corporation has no statutory or charter authority to make a gift, the corporation may not be compelled to complete the gift. Moreover, if it is completed, a dissenting stockholder or a creditor whose rights have been impaired may redress the wrong committed against him.

In addition, in income tax cases in which the recipient of a corporate payment makes a convincing showing of a corporate intent to make a gift—upon which argument recipients often try to prevail—the distinction between void and voidable, may be insignificant. This is especially true if there is no statutory authority for the corporation to make a gift, or if the corporate charter is in evidence to show no power in the corporation to make a gift. In fact, an attempt to establish a corporate intent to make a gift is to contradict the sound view that corporation action is presumed regular until shown to be otherwise. The making of a gift by a business corporation would be irregular if the corporation were shown to have neither statutory nor charter power to make one. Thus, it is appropriate to conclude that, in exempting gifts, the Congress meant true gifts in the generally accepted sense of that word, not payments by a "donor" with no legal power to give.

Of course, if all the stockholders consent and if it is not detri-

¹⁷ Int. Rev. Code, § 162(b).

¹⁸ *Detroit Edison Co. v. Commissioner*, 131 F.2d 619 (6th Cir. 1942), *Commissioner v. Montague*, 126 F.2d 948, 951 (6th Cir. 1942); *Botchford v. Commissioner*, 81 F.2d 914 (9th Cir. 1936); *Noel v. Parrott*, 15 F.2d 669 (4th Cir. 1926).

¹⁹ Long before the inception of the present income tax system a gift had been defined as a voluntary conveyance of land or other property, from one person to another, made gratuitously, and not upon any consideration of blood or money. 2 Blackstone (Lewis), Commentaries 440 (1902 ed.).

²⁰ 6A Fletcher, *Cyclopedia Corporations*, 667-68, ¶ 2939 (1950 ed.).

mental to creditors, even the corporate officers may appropriate corporate assets.²¹ In other words, an appropriation of corporate assets may be made where the stockholders and the creditors do not object.²² But it does not follow that the appropriation of corporate assets is a gift. "Any power sought to be exercised as incidental or auxiliary must be *one which is within the scope and purview of the corporate objects and purposes as expressed in the charter.*"²³ (Emphasis supplied.)

Thus, stockholders may approve and creditors may assent and thereby lose their right of redress in court. But this approval does not change the character of the transaction. It does not bestow upon the corporation a power to make gifts where the corporation does not have such power by statute or under its charter. In short, ratification of an alleged gift does not cure its illegality; it constitutes nothing.²⁴ The Supreme Court has pointed out that if the payment constitutes an illegal gift of corporate funds and amounts to waste, the fact that the contract was ratified by the stockholders does not cure its illegality.²⁵

EVIDENTIARY PROBLEMS

A. *Corporate Charter*

The difficulty in finding a tax case in which the court has considered the corporation's lack of power to make a gift is apparently due to the lack of record evidence on the issue of the absence of such power in the corporation. Although, as previously noted, the general rule is that business corporations are not given authority by statute or by charter to make gifts other than to certain described charities. Nevertheless if the certificate of incorporation with its charter powers is not adduced as evidence, it would seem that the court may not properly presume that the corporation has no power to make a gift. In the leading case on this point the court said:

The bill does not set out a copy of the certificate of incorporation with its charter powers, nor are they otherwise stated in the bill.

The allegation that certain acts are ultra vires is there-

²¹ Sayre Land Co. v. Borough of Sayre, 5 Pa. D. & C.2d 294, 121 A.2d 579 (1956).

²² Gilbert Mfg. Co. v. Goldfine, 317 Mass. 681, 59 N.E.2d 461 (1945); Southern Hide Co. v. Best, 174 La. 748, 141 So. 449 (1932).

²³ Premium Point Co. v. Emigrant Industrial Sav. Bank, 36 N.Y.S.2d 829, 832 (Westchester County Ct. 1942). See The Robin Goodfellow, 20 F.2d 924 (W.D. Wash. 1927); Heinz v. National Bank of Commerce, 237 Fed. 942 (8th Cir. 1916).

²⁴ Kerbs v. California E. Airways, 33 Del. Ch. 174, 91 A.2d 62 (1952).

²⁵ Rogers v. Hill, 289 U.S. 582 (1933).

fore the statement of a conclusion, and not a proper pleading of facts.

* * * * *

*If, in fact, there is no provision in the charter which authorizes the majority stockholders to pay out corporate funds without consideration, then we are of opinion that the bill does have equity.*²⁶ (Emphasis supplied.)

B. Stockholder Approval

The income tax decisions also show that approval by the stockholders is at times apparently considered evidence of an intent to make a gift. That is of course not so. If the state statute does not grant the corporation the power to make gifts of the nature herein involved, or if the charter does not empower the corporation to make such gifts, ratification by the stockholders may mean nothing.²⁷ Or, as was said in one case:

"It is a universal rule that neither the board of directors nor the majority stockholders can, over the protest of a minority stockholder, give away corporate property."²⁸

Even if all the stockholders do approve such an action, there remain the rights of creditors who are entitled not to have their claims jeopardized by the corporation's giving away of its assets.²⁹

CHALLENGE OF THE PAYMENT BY RECIPIENT

The right of the recipient of a payment from a corporation to maintain that the payment constitutes a gift is questionable. If the payment were in reality a gift, he, having taken it, has participated in an incompetent and invalid act and thus could not come into court with the necessary clean hands. For the recipient of a payment to contend that the payment is a gift and exempt from tax is tantamount to saying that although he unlawfully received the payment and maintains a right to keep it, he seeks a declaration by the court that his ill-gotten gain is a gift and thus exempt from the tax. He wants, and he keeps, the ill-gotten gain; but he wants it tax-free.

Under corporate law, the recipient's participation in such an unlawful act would necessitate his repayment of the amount received

²⁶ Adams v. Smith, 275 Ala. 142, 145, 153 So. 2d 221, 223 (1963).

²⁷ Rogers v. Hill, supra note 25; United Community Services v. Omaha Nat'l Bank, 162 Neb. 786, 77 N.W.2d 576 (1956); Sayre Land Co. v. Borough of Sayre, supra note 21; Gottlieb v. McKee, 34 Del. Ch. 537, 107 A.2d 240 (1954); Kerbs v. California E. Airways, supra note 24; Western Indus. v. Vilter Mfg. Co., 257 Wis. 268, 43 N.W.2d 430 (1950); McDonough Corp. v. Connolly, 313 Mass. 62, 46 N.E.2d 576 (1943); McLaughlin v. Corcoran, 104 Mont. 590, 69 P.2d 597 (1937).

²⁸ Adams v. Smith, supra note 26.

²⁹ Western Indus. v. Vilter Mfg. Co., supra note 27, quoting 3 Thompson, Corporations, 989, § 2301 (3d ed.).

before he could remove his obligation to pay taxes on it. But as long as he holds the payment under a claim of right, it is quite inconsistent for him to contend that the payment is a gift, for to make this contention where the corporation has no statutory or charter power to make the gift is equivalent to saying that he received the payment unlawfully.

CORPORATE POWERS: THE MODERN TREND

Though error has led to considerable confusion in the treatment of alleged gifts for income tax purposes, there is also a positive point of view. Unless the corporation has statutory authority or charter power to make the alleged gift, we should begin with a presumption that the payment by the corporation is one made as properly within the corporate power, and not a gift. The leading tax decision supporting this view is *Fifth Avenue Coach Lines, Inc. v. Commissioner*, where the Tax Court said:

*It must be presumed that the petitioner's board of directors in authorizing Sheeran's salary increase and the payments to Sheeran's widow was acting validly and reasonably; neither Sheeran nor his widow was a stockholder of petitioner, and the rule of close scrutiny of transactions involving stockholder-officers is not applicable here.*³⁰ (Emphasis supplied.)

For example, if the recipient is an officer or employee and not a stockholder, the payment ordinarily will be presumed to be for services, taxable to him as such but deductible by the corporation to the extent that it constitutes reasonable compensation when considered along with other compensation paid to the recipient. In case the officer or employee is a stockholder, the amount received by him may be lawfully paid to him as a dividend, unless he is a dominant stockholder or a director and obtains it under circumstances that disregard the rights of others.

Note that if the charter powers had been in evidence before the Tax Court in another important case, *Schner-Block Co., Inc. v. Commissioner*,³¹ and if it had been shown that the corporation had not been granted any power to make a gift or gratuity, the court may have felt compelled to adopt the views advanced in this paper. Rather, in deny-

³⁰ 31 T.C. 1080, 1093 (1959). In fact, in the first case decided by the United States Board of Tax Appeals (now the Tax Court of the United States) the Board, in Appeal of John H. Parrott, *supra* note 14, at 4, stated: "Corporate action is presumed regular until shown to be otherwise. The payment of a bonus would be regular, the making of a gift would be irregular."

³¹ 22 CCH Tax Ct. Mem. 796 (1963). See *Rubber Associates, Inc. v. Commissioner*, 22 CCH Tax Ct. Mem. 567 (1963) for a similar view.

ing a deduction to the corporation, the court in *Schner-Block* pointed out that the corporation

[H]as not borne the burden of showing that this was not either a "gratuity" from the shareholders to the widow or a distribution by petitioner which, with the consent of all the shareholders, she was enabled to receive. In neither case would it be deductible by petitioner.

Hence, as evidenced by the decision in this case, the failure to show the charter powers may work against the corporation, particularly in cases where the payment is to a non-stockholder who is an officer or employee. It may, however, also do so where the payment is to the widow of a deceased officer or employee.³² Certainly, the introduction of the charter powers into evidence would preclude the application of any theory that "gift" and "compensation" may overlap.³³

In the opinion of this writer, the true rationale in cases such as *Noel v. Parrott*,³⁴ *Old Colony Trust Co.*,³⁵ and others holding the officer or employee taxable, has been based upon an effort to presume, even in the absence of evidence of the charter powers, that the payment was lawfully made by the corporation, and that being so, it was not a gift but taxable compensation to the recipient. Moreover, since payment of a dividend is within the corporate power, the same rationale appears to be applicable to those cases in which payments ostensibly made as compensation were held to be dividends to officer-stockholders or employee-stockholders.

Where the charter powers of a corporation are in evidence, they should be construed in light of the modern conditions which give a business corporation greater powers. These are not greater powers to make gifts; instead, they are powers to take all action reasonably deemed necessary in the promotion of the corporation's business purpose.

In view of changing business policies and methods, a court should not perfunctorily substitute its business judgment for that of the corporate officials. If the payments have been properly authorized, particularly if approved by the stockholders, there should be a presumption that the payment was made for an authorized business purpose. This was recognized by a Delaware court when, in considering the right of directors to purchase corporate stock at less than the market price, it said:

³² See *Harry L. Davis Co. v. Commissioner*, 20 CCH Tax Ct. Mem. 1043 (1961).

³³ This theory was expressed by Mr. Justice Brandeis, dissenting in *Bogardus v. Commissioner*, 302 U.S. 34, 44 (1937). See *Peters v. Smith*, 221 F.2d 721 (3d Cir. 1955), in which reference was also made to the theory of overlapping.

³⁴ See *supra* note 18.

³⁵ *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929).

Where the directors have represented both themselves and the corporation, and where there was no ratification by stockholders, and the action is thereupon duly challenged, the court will usually have no choice but to employ its own judgment in deciding the perhaps very close and troublesome questions. . . . Where there was stockholder ratification, however, the court will look into the transaction only far enough to see whether the terms are so unequal as to amount to waste, or whether, on the other hand, the question is such a close one as to call for the exercise of what is commonly called "business judgment."

In the former case the court will reverse the decision of the stockholders; in the latter it will not.³⁶

In short, though the court cautiously pointed out the difficulty where directors vote themselves a benefit, it leaned heavily toward a presumption that stockholder approval connotes lawful and business-like action by the directors.

EFFECT OF VOID GIFT

A. *No Deduction by Corporation*

The author recognizes that a business corporation may actually perform an act of giving away assets, despite a lack of power to do so. If such action is taken, however, clearly the corporation has not incurred an ordinary and necessary business expense deductible in computing its taxable income, for a transfer of assets does not constitute an ordinary and necessary business expense where it is outside the power of the corporation and no reasonably adequate consideration is received. Thus, the rule respecting deductibility by the corporation is the same, whether the gift is within or without the powers of the corporation.

B. *No Exemption to Recipient*

An alleged gift which is illegal, void, or ultra vires is not necessarily exempt from a tax in the hands of the recipient. True, by state statute an ultra vires conveyance of property may not be invalid as such, but a stockholder may proceed against the corporation and the corporation against the officers who make the conveyance. In exempting gifts from tax, Congress presumably did not mean to exempt gifts made under such circumstances, but intended only to exempt true gifts made by persons who are competent to make them and who incur no liability in so doing. This view finds support in a decision by the

³⁶ *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 179, 91 A.2d 57, 58 (1952).

Court of Appeals for the Second Circuit holding an individual taxable on an illegally received and retained bonus.⁸⁷

WHEN GIFT IS NOT DIRECTLY BY CORPORATION

Even under the theory explained above, there may be instances in which the corporation has not made a gift and yet the ultimate recipient of the payment may have received one and hence is not subject to tax. Suppose a corporate officer dies and by resolution of the stockholders it is decided to pay his widow "a gratuity." Also suppose that the dominant stockholder who owns ninety per cent of the stock and control of the corporation is the father of the deceased and votes in favor of the resolution. In a case such as this, it is not beyond the realm of probability that the widow may appropriately maintain that she received a gift. In doing so, she should, however, not contend that the corporation made a gift to her. Instead, her argument may be that the dominant stockholder, her father-in-law, received a constructive dividend and that he in turn made the gift to her.

Though the point has apparently not been litigated under circumstances such as these, it may merit consideration in view of the holdings that a dividend need not be formally declared as such, that it need not be distributed pro rata, and that it need not be so characterized.⁸⁸

CONFLICT OF INTEREST CASES

Special consideration may appropriately be given to the true nature of the transaction where the recipient of the alleged gift casts the deciding vote as a director or as the dominant stockholder. This type of case may be more prevalent in close corporations or in corporations where there are more than one class of stock with voting rights limited to one class, in which a dominant stockholder or group of stockholders cast the deciding votes.

Respecting the relationship of a director to the corporation, it is well settled that directors and other officers, "while not trustees in the technical sense in which that term is used, occupy a fiduciary relation to the corporation and to the stockholders as a body."⁸⁹ Decisions in many states may be cited as authority for this proposition. The leading case, however, is *Pepper v. Litton*,⁴⁰ in which the Supreme Court dis-

⁸⁷ *National City Bank v. Helvering*, 98 F.2d 93 (2d Cir. 1938).

⁸⁸ See *Barbourville Brick Co. v. Commissioner*, 37 T.C. 7, 13 (1961) and cases cited therein; *Appeal of the Pompeian Mfg. Co.*, 1 B.T.A. 825 (1925); *Appeal of Reliant Leasing Co.*, 1 B.T.A. 728 (1925); *Breslin v. Fries-Breslin Co.*, 70 N.J.L. 274, 58 Atl. 313 (1904).

⁸⁹ 3 Fletcher, *Cyclopedia Corporations*, 173, ¶ 838 (1950 ed.).

⁴⁰ 308 U.S. 295 (1939). See *In re Norcor Mfg. Co.*, 109 F.2d 407 (7th Cir. 1940), *cert. denied*, 310 U.S. 625 (1940), quoting and following *Pepper v. Litton*; and see *Seder v. Gibbs*, 333 Mass. 445, 453, 131 N.E.2d 376, 380 (1956), which adopts a similar view and

cussed the relationship of a dominant stockholder and a director to his corporation. "A director is a fiduciary," the Court said, as is "a dominant or controlling stockholder or group of stockholders." Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny, and where any of their contracts or engagements with the corporation are challenged, the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness to the corporation and other interested parties. The essence of the test is whether under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, a court of equity will set it aside.

All too often when this position is taken in an income tax case, we regard it as something peculiar to the tax field, *i.e.*, as an effort to prevent tax avoidance. This is, however, not so. It is the law of the land. In *Pepper v. Litton*, the Supreme Court was most emphatic:

He who is in such fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. . . . *He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be* and no matter how meticulous he is to satisfy technical requirements.⁴¹ (Emphasis supplied.)

In *Barbourville Brick Co. v. Commissioner*,⁴² there was a multiple conflict of interest. The recipient of the payment was the widow of a deceased officer of the corporation. She not only cast the deciding vote in favor of the alleged gift but, as administratrix of the estate of her deceased husband and as guardian of each of her two sons, she voted against the interests of the estate and of her children. Out of 180 shares of corporate stock, she owned only 32, and her father-in-law, who voted with her, owned 12. Thus, her father-in-law with his 12 shares was the only one who could, perhaps, claim that he had no conflict of interest. Under these circumstances there was no valid vote to pay the widow anything. It was therefore correct to hold, as the Tax Court did, that the corporation was not entitled to a deduction. In so doing, however, the court gave a specious reason, namely, that the payment to the widow constituted a dividend. The deduction

states as to the directors' relationship to the corporation: "They cannot be permitted to serve two masters whose interests are antagonistic."

⁴¹ *Pepper v. Litton*, *supra* note 40, at 311.

⁴² See *supra* note 38.

would have been more appropriately denied on the ground that the payment was not made pursuant to any valid resolution, that it was made in violation of the rule stated in *Pepper v. Litton*, and that hence it was not an ordinary and necessary business expense.

BONUSES TO OFFICERS OR EMPLOYEES

A. *Early History*

The early administrative position taken under the Act of 1913 leaned toward the disallowance of a corporate deduction for bonuses paid to employees.⁴³ Special payments made by a corporation, even if allegedly made as extra compensation to certain employees, were said to be deductible by the corporation only if two requirements were met: (1) that it was clearly shown that the payments were made as compensation for services rendered; and (2) that they were paid in pursuance of a contract expressed or implied. It seemed to have been assumed that a business corporation may make a gratuity. The payment was said to be taxable to the recipient if it was made as compensation for services.

Later, under the 1916 Act, the published administrative position was that special payments, sometimes denominated gifts or bonuses, were a part of the compensation of the employee for services rendered, the amount of which was deductible by the corporation and taxable to the recipient. A similar position was taken respecting such payments when made to officers.⁴⁴ But it was also recognized that the payments may be in the nature of dividends or distributions of profits, if made to officers or employees who are also stockholders and if such payments are based upon or bear a close relation to the stockholdings of the recipients. In this event, the payments are taxable to the recipients but not deductible by the corporation. This position is still true today.⁴⁵

Except under the Act of 1913, the regulations have tested the deductibility by reference to the reasonableness of the amount as compensation for services rendered. Thus, from the beginning, this test of deductibility was anticipated, though it was not expressly included in the taxing statute until the enactment of the Revenue Act of 1918.⁴⁶

⁴³ T.D. 2152, 17 Treas. Dec. Int. Rev. 95 (1915).

⁴⁴ T.D. 2616, 19 Treas. Dec. Int. Rev. 405 (1917).

⁴⁵ Treas. Reg. § 1.162-9 (1958). Although the regulations under the 1918 and 1921 Acts spoke of the possibility that certain donations to employees and others might be considered gratuities and therefore not deductible by the corporation, they should be construed as being particularly applicable to individuals and partnerships who are competent to make gifts. Hence, it is not to be inferred that these regulations were promulgated on the assumption that a business corporation has a general power to make gifts.

⁴⁶ Revenue Act of 1918, ch. 18 § 214(a)(1), 40 Stat. 1066 (1918); ch. 18 § 234(a)(1), 40 Stat. 1077 (1918).

B. Reasonableness of Bonus

The main thrust of the test of reasonableness may be felt, not so much in the case of a voluntary payment to an employee as such, who is not a stockholder, but especially in the case of an officer or employee who is also a stockholder. In the latter instance, ordinarily the main object is to determine whether the payment constitutes compensation for services rendered or is rather a distribution of a dividend. Though ostensibly paid as compensation for services rendered, if the payments correspond or bear a close relationship to the stockholdings, they may in reality be dividend distributions, for, as explained above, a dividend need not always be distributed pro rata. Though the payment is made to only one stockholder, and though the stockholder is an officer or employee, nevertheless there are circumstances in which it may be a dividend, taxable as such to the recipient, and not deductible by the corporation in computing taxable income.

What is more, it is implicit in the previous discussion of a conflict of interest that if a dominant stockholder votes himself excessive compensation, he is taxable on it, not solely because the payment may constitute a dividend, but perhaps more because it is a misappropriation of corporate assets. Conceivably such stockholder may also be taxable, though the payment is made to another employee such as one who happens to be a close relative of the dominant stockholder.

The issue of the proper classification of such a payment—as compensation deductible by the corporation, as a dividend, or as a misappropriation of corporate funds—is one that arises mainly in the case of a closely controlled corporation. The rule holds that the amount is taxable to the recipient, but is deductible by the corporation only if it constitutes reasonable compensation for services rendered. If there is a misappropriation for the benefit of a relative or other beneficiary of a dominant stockholder, the primary question may be to determine the true recipient, that is, whether the dominant stockholder constructively received the amount misappropriated by his action.

C. When Deductible

Where a bonus is voted "for past services" and the corporation reports on the accrual basis, the reasonableness of the bonus as compensation is determined not solely by reference to the services rendered within the taxable year in which the bonus is voted.⁴⁷ If the bonus is

⁴⁷ *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930) is the leading case on this point. Prior to the decision in that case, it was held in some cases that the bonus authorized and paid as additional compensation for prior years was not deductible in

paid in a lump-sum within the year in which it is authorized, it may be deducted by the corporation for the year in which it is authorized. But if payment is deferred over two or more years, it may be deducted only as and when paid, though the corporation has adopted the accrual method of accounting for income tax purposes. This result is expressly required by statute.⁴⁸

PAYMENTS TO WIDOWS

A. Regulations

The income tax problem respecting payments to the widow of a deceased corporate officer or employee goes back to the beginning of our present federal income tax system in 1913. That this is so is evidenced by a Treasury Decision promulgated December 14, 1914:

Where the monthly salary of an officer or employee is paid for a limited period after his death to his widow in recognition of the services rendered by the husband, no services being rendered by the widow, it is held that such payment is a *gratuity* and exempt from taxation under the income tax law. Such a payment would *not*, however, be an allowable deduction as an expense of carrying on business in the return of the person, firm or *corporation* paying same.⁴⁹ (Emphasis supplied.)

This position was apparently maintained until regulations were issued under the Act of 1918. However, beginning with those regulations and continuing up to and including the regulations under the 1939 Code, the deduction was allowed. On the other hand, the regulations were silent on the question of whether the amount paid to the widow constituted income.

B. Rulings

In 1921, a ruling⁵⁰ was issued stating that where a corporation pays to the widow of a deceased officer a certain amount equal to the salary he would have earned in two months, the payment being without consideration and constituting a gratuity voted as a compliment to the deceased, the payment does not constitute taxable income.

This ruling, when read in conjunction with the regulations in the year so authorized and paid. In other cases, it was held that additional compensation for a prior year was not deductible in any year, if authorized after the close of the prior year for which it was authorized.

⁴⁸ Int. Rev. Code, § 404(b) requires that deferring the receipt of compensation shall be treated as a plan deferring the receipt of compensation which by § 404(a) is deductible only in the taxable year when paid.

⁴⁹ T.D. 2090, 16 Treas. Dec. Int. Rev. 259 (1914).

⁵⁰ O.D. 1017, 5 Cum. Bull. 101 (1921).

effect at that time, put the Service in the position of saying on the one hand that the payment is a gift and not taxable to the widow, and, on the other hand, that it is deductible from gross income by the corporation. This ruling was outstanding for twenty-nine years before it was revoked in 1950 by a ruling⁵¹ that payments made by an employer to the widow of a deceased officer or employee in consideration of services rendered by such officer or employee, are includible in the gross income of the widow. However, as a practical matter, due to a later announcement,⁵² this ruling did not become generally effective until the enactment of the 1954 Code.

C. Present Position

Today, the official position is a complete reversal of the one assumed in 1914. The earlier attitude was not to tax the widow and not to allow the corporation a deduction. Then, for a time, the position was to allow the corporation a deduction, but not to tax the widow. Now, the official position of the Internal Revenue Service is that payments to "widows" generally are not gifts.⁵³

One theory in support of this position is its Congressional endorsement, in substance, when the 1954 Code specifically provided that the widow of a deceased employee may exclude up to \$5,000 of the amount paid to her by her deceased husband's employer.⁵⁴ This section would have been unnecessary were the payment a gift.

D. Judicial View

Since the Supreme Court decision in *Commissioner v. Duberstein*,⁵⁵ the Tax Court has held that voluntary payments to a widow of a deceased employee are not gifts.⁵⁶ Some federal courts agree;⁵⁷ other courts do not.⁵⁸

⁵¹ I.T. 4027, 1950-2 Cum. Bull. 9.

⁵² See Rev. Rul. 58-613, 1958-2 Cum. Bull. 914, in which the Internal Revenue Service announced that it would no longer litigate such cases involving widows which arose under the 1939 Code.

⁵³ Rev. Rul. 62-102, 1962-2 Cum. Bull. 37, modifying Rev. Rul. 60-326, 1960-2 Cum. Bull. 32.

⁵⁴ Int. Rev. Code, § 101(b).

⁵⁵ 363 U.S. 278 (1960).

⁵⁶ *Penick v. Commissioner*, 37 T.C. 999 (1962); *Westphal v. Commissioner*, 37 T.C. 340 (1961). In accord are several Tax Court memorandum opinions.

⁵⁷ See *Carson v. United States*, 317 F.2d 370 (Ct. Cl. 1963); *Gaugler v. Commissioner*, 312 F.2d 681 (2d Cir. 1963); *Smith v. Commissioner*, 305 F.2d 778 (3d Cir. 1962); *Martin v. Commissioner*, 305 F.2d 290 (3d Cir. 1962); *Froehlinger v. United States*, 217 F. Supp. 13 (D. Md. 1963); *Hein v. United States*, 205 F. Supp. 365 (E.D. Wis. 1962).

⁵⁸ *Olsen v. Commissioner*, 302 F.2d 671 (8th Cir. 1962); *United States v. Frankel*, 302 F.2d 666 (8th Cir. 1962); *Poyner v. Commissioner*, 301 F.2d 287 (4th Cir. 1962); *Kuntz v. Commissioner*, 300 F.2d 849 (6th Cir. 1962); *United States v. Kasynski*, 284 F.2d 143 (10th Cir. 1960).

Fundamentally, it may be that all of these cases proceed upon the same basis, namely, that the issue is one of fact and the object is to discover the dominant motive for the payment to the widow. In ascertaining the motive, the court may look to one or more of the following factors: (1) the payments are made to the widow of the deceased employee and not to his estate; (2) there is no obligation on the part of the corporation to pay any additional compensation to the deceased employee; (3) the corporation derives no benefit from the payment; (4) the widow performed no services for the corporation; (5) the services of the husband had been fully compensated; (6) the widow is in good financial condition; (7) her health is good or poor, as the case may be.

Resort to these and other similar tests generally occurs where there is no evidence that the corporation lacks statutory authority or charter power to make a gift. Even so, the tests are rather superficial.

Whether the payment is made to the widow or to the estate of the deceased employee is wholly immaterial if the widow is the sole beneficiary, the sole residuary legatee under the deceased's will, or if, as has been held in at least one case,⁵⁹ the payment cannot be a part of the deceased employee's estate since no contract existed under which payment could have been enforced. In this latter example, since the payment was authorized after the death of the husband, the estate never became entitled to it, and the executor has no authority to make distribution of it. Under these circumstances, the fact that payment is made to the widow appears to fall far short of rebutting the sensible presumption that the payment is for services rendered by her husband.

It also is quite unrealistic to test the nature of the payment by the fact that the corporation was under no expressed or implied obligation to make the payment. Many corporate payments for good business reasons are made voluntarily. Nor does it follow that the payment is a gift, even if a payment is voluntarily made for no discernible business reason. It cannot be a gift if the corporation has no power to make one. It may be a misappropriation of corporate funds, or, if the recipient is a stockholder, it may be a dividend.

Moreover, even if the payment is not a dividend or a misappropriation of corporate funds, to say that the corporation derived no benefit from it is to substitute the opinion of the court for the sound judgment of the responsible corporate officials or of the stockholders, without there being convincing proof that their judgment is not sound. The same observation may also be made respecting a court's conclusion that the services of the deceased husband have been fully compensated.

⁵⁹ *Wanner v. Commissioner*, 83 F.2d 1022 (2d Cir. 1936).

What is even more vulnerable is that the tests proceed not from a presumption that the corporation acted properly, but upon the basis that the burden of proof is upon the party who denies that the payment is a gift. Admittedly, if the Commissioner of Internal Revenue determines that a corporation has made a gift that is not deductible by the corporation, his determination is *prima facie* correct. In such case, the corporation has the burden of producing sufficient evidence to warrant a finding of error in the Commissioner's determination. This is to say that the corporation should at least produce its charter to show that it has no power to make a gift. On the other hand, if the Commissioner has determined that the payment is income to the widow of a deceased officer or employee but she claims that it is a gift, the widow really has no basis for probative evidence that the payment is a gift unless she first shows that the corporation has charter power or statutory authority to make a gift.

There is no question in the mind of this writer that the decisions holding that there is a gift to the widow may reflect some effort to follow the Supreme Court decision in *Stanton v. United States*.⁶⁰ In the *Stanton* case, the payment was by a wholly owned subsidiary of a church to a retiring officer of the subsidiary. The subsidiary was apparently not an ordinary business corporation. It could have been an instrumentality or agency⁶¹ of the church. Perhaps it was. Be that as it may, there was no showing that it lacked the authority or the power to make a gift. In short, there was no evidence squarely contradicting the alleged intention to make a gift. Thus, the case did not involve the competency or the power of an ordinary business corporation to make a gift.

On the other hand, it may be true that, in cases involving payments to widows, the Supreme Court decision in *Bogardus v. Commissioner*⁶² has exerted a stronger influence than has the *Stanton* case. In *Bogardus*, payments were made by corporation B to Bogardus and others who had been employees of corporation A, all of whose stock and assets had been taken over by corporation B.

Here again the record apparently did not contain any evidence that corporation B had no power to make gifts. What is more, by

⁶⁰ 363 U.S. 281. The companion case was *Duberstein v. Commissioner*, *supra* note 55.

⁶¹ A number of decisions emphasize that ownership alone of stock in one corporation by another does not create an identity of corporate interest between the companies or create the relation of principal and agent or representative between the two. See, for example, *Chicago M. & St. P. Ry. v. Minneapolis Civic Ass'n*, 247 U.S. 490 (1918). This rule is not controlling where the parent corporation does not participate in the normal and usual manner as a stockholder. However, as stated in the leading case, *NLRB v. Denna Artware, Inc.*, 361 U.S. 398, 402-403 (1960), quoting *Berky v. Third Ave. Ry.*, 244 N.Y. 84, 95, 155 N.E. 58, 61 (1926), dominion may be so complete that by the general rules of agency the parent is a principal and the subsidiary an agent.

⁶² See *supra* note 33.

stipulation of the parties, the payments were not made or intended to be made for any services rendered or to be rendered or for any consideration given or to be given by any of the recipients or to the corporate stockholders of the corporation making the payments. Thus, the stipulation clearly contradicted any reasonable presumption that the payments were made for services rendered or for any other consideration.

In view of this artificial record, it is not surprising that the payments were held not to be taxable to the recipient. Nor is it surprising to see different courts refer to the *Bogardus* case as a basis for reaching different results in different cases. They seemingly start with the hypothesis that a business corporation has the power to make gifts, which may be a sound, cautious hypothesis when there is no evidence to contradict it. Thus, whether the payment is made to the widow of a deceased officer or employee or to a stranger, the nub of the confusion is in a failure to show no statutory authority and no charter power for the corporation to make a gift.

SUMMARY AND CONCLUSION

In his book *Crossroads: 1913*,⁶³ Paul M. Angle concludes that the year 1913 marked the end of a Golden Age and the beginning of a New Era. In a sense this may be true. Significantly, however, the book was written fifty years later when the author could look back and reasonably appraise the events of 1913. To see what has been done and to adjust ourselves accordingly takes time. This is particularly true in the law, for in the law stability is important. It is also important, because, as in the taxation of corporate bonuses, there may be a period of uncertainty respecting the decisive facts.

It was therefore quite a sound step forward when in 1926, without mentioning any lack of corporate power to make a gift, the Court of Appeals for the Fourth Circuit reversed the district court and held in *Noel v. Parrott*⁶⁴ that a corporate payment to an officer was not a gift but constituted compensation for services. This conclusion was reached, notwithstanding the fact that the payment was made pursuant to a resolution that "a gratuitous appropriation . . . be set aside . . . for distribution to certain officers and employees of the company."⁶⁵ (Emphasis in original.)

In 1929, in the *Old Colony Trust Co.* case,⁶⁶ the Supreme Court made it even more certain that as a general rule bonus payments to officers or employees constitute compensation for services taxable to

⁶³ Angle, *Crossroads: 1913* (1953).

⁶⁴ See *supra* note 16.

⁶⁵ *Ibid.*

⁶⁶ See *supra* note 35.

the recipient. Moreover, the practical application of this rule was enhanced in 1930 when, in the *Ox Fibre Brush Co.* case,⁶⁷ the Supreme Court held that the payments may be deducted by the corporation though they are for services rendered in prior years.

On the other hand, if the payment is really a dividend distribution made in the guise of a compensatory bonus, it does not come within this general rule.⁶⁸ In such case, the dividend is taxable, but no deduction is allowable to the corporation. There may, of course, be no valid dividend if a dominant stockholder authorizes payment to himself and not to all other holders of the stock; or if the directors alone authorize payment to themselves and not to other stockholders; or if the recipient authorizes the payment by voting his own stock and other stock which he holds in a fiduciary capacity. Even if the dividend is found to be invalid, however, it may be taxed to the recipient where he holds it under a claim of right. In other words, no dividend, valid or invalid, may be deducted as an ordinary and necessary expense of the corporation.

The general rule applied to bonuses paid to corporate officers or employees should be applied to a bonus payment made by a corporation to the widow of a deceased officer or employee. Whether the payment is a gift, or is compensation, depends upon the generally accepted meaning of "gift," rather than upon particular state law. In the usual case, it is inconceivable that such payment would be made to the widow were the deceased never employed by the corporation. In short, the only sensible reason for the payment is that it is additional compensation for services rendered by the deceased husband. On the other hand, if the widow alone authorizes payment to herself by voting stock she owns or stock which she holds in a fiduciary capacity, the payment, though taxable to her, may not be deductible by the corporation. Conceivably, however, the payment may be a gift to her if it is in substance a constructive dividend to a dominant stockholder or group of stockholders.

In the opinion of the writer, this is the direction in which the law of income taxation relative to corporate bonuses is moving. If it is not—if confusion continues—uncertainty may spread, but not to disturb presently recognized rights of minority stockholders and of creditors,

⁶⁷ See *supra* note 47.

⁶⁸ It may, however, pose new issues for established corporation law. To illustrate, suppose that, in authorizing payment of a bonus, the corporate directors adopt an inept resolution which deprives the corporation of its right to deduct the payment and causes it to pay additional income tax. Do they personally incur a liability for the amount of the additional tax? See *In re Inman's Estate*, 22 Misc. 2d 573, 196 N.Y.S.2d 369 (1959), in which the executors elected to deduct certain expenses for income tax purposes rather than deduct them in computing the estate tax. The court directed that the estate be reimbursed by the amount of the additional estate tax incurred by reason of this election.

and not to mollify liabilities of those who improperly authorize the payment of alleged bonuses. In so far as corporation law or the law of gifts is related to the income tax problems here discussed, it is well settled; our problem is to apply its principles correctly in determining the facts of legal import in income taxation.

Thus, here is a subject in which the mystery of income tax law is in the selection of the facts of legal import. This being so, we should perhaps give greater weight to the words of the legendary practical judge. "Let me find the facts," said he, "and I don't care who writes the opinion of the court."