



UNC
SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 39 | Number 3

Article 8

4-1-1961

Federal Income Taxation -- Non Taxable Gift Versus Taxable Compensation

Francis N. Millett Jr.

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

Recommended Citation

Francis N. Millett Jr., *Federal Income Taxation -- Non Taxable Gift Versus Taxable Compensation*, 39 N.C. L. REV. 286 (1961).
Available at: <http://scholarship.law.unc.edu/nclr/vol39/iss3/8>

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.

not a described tract of land, but a "life estate in and to the following described tract of land."²⁰

Oxendine points to the possible necessity that the court in the future may have to define the "granting clause" with some exactness. At the present various interpretative problems might arise in application of the *Artis-Oxendine* rule, such as: where the granting clause begins and ends, and therefore, whether or not particular words are included; whether a draftsman using a form deed can add to the printed granting clause, and if so, what is the result of conflicting words within the granting clause. Thus it is questionable whether the presumably desired result of certainty has yet been achieved.

H. MORRISON JOHNSTON, JR.

Federal Income Taxation—Non Taxable Gift Versus Taxable Compensation.

Frequently the taxpayer must decide whether a particular payment is the receipt of income in the form of compensation¹ or a non-taxable gift.² The decision is problematical, for the legal distinctions between them are nowhere clearly expressed. If the taxpayer cautiously classifies the receipts as compensation, he might increase his tax burden needlessly. Alternatively, his election to exclude such receipts from gross income faces possible challenge by the Commissioner of Internal Revenue.

Recently the Supreme Court of the United States decided three cases involving the "gift versus compensation" issue.³ The case of *Commissioner v. Duberstein*⁴ grew out of a fairly common business situation. The taxpayer, president of a corporation and a business friend of one Berman, president of another corporation, supplied at Berman's request the names of potential customers for Berman's com-

²⁰ In *Oxendine* the court clearly did not consider the inserted material part of the granting clause, but there was a dissent as to this. Also, in *Oxendine* the majority merely laid down a rule of exclusion, which leaves much to be desired as to definiteness.

¹ INT. REV. CODE OF 1954, § 61(a): "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, and similar items. . . ."

² INT. REV. CODE OF 1954, § 102(a): "Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance."

³ "The Government, urging that clarification of the problem typified by these two cases was necessary, and that the approaches taken by the Courts of Appeal for the Second and the Sixth Circuits were in conflict, petitioned for certiorari. . . . On this basis, and because of the importance of the question in the administration of the income tax laws, we granted certiorari. . . ." *Commissioner v. Duberstein*, 363 U.S. 278, 283-84 (1960).

⁴ 363 U.S. 278 (1960).

pany. Berman offered to give the taxpayer a Cadillac car, but the taxpayer did not need or desire a car, nor had he expected compensation. Nevertheless, he reluctantly agreed to accept the car. He did not include the value of the car in his gross income. The Commissioner assessed a deficiency and the Tax Court affirmed. The Court of Appeals for the Sixth Circuit reversed.⁵

The case of *Stanton v. United States*⁶ concerned the payment of a "gratuity" to an employee by his employer at the time of his resignation. The taxpayer had been employed approximately ten years as comptroller of a corporation and as president of its wholly owned subsidiary, receiving an annual salary of \$22,500. The directors voted a gratuity of \$20,000 in appreciation of his services, provided he relinquish all rights and claims to any benefits from the corporation's retirement and pension funds other than a return of his contributions to the fund. He was not required to furnish any services after his resignation. In a refund suit, the district court sitting without a jury found that the payments were a gift. The Court of Appeals for the Second Circuit reversed.⁷

The case of *United States v. Kaiser*⁸ presented the question of whether payments by a labor union constitute a gift or taxable income to a striking non-member. The taxpayer was employed by the Kohler Company when the UAW called a strike at the company's plant in 1954. He was not a member of the union but he did support the strike. Having no other means of support and not being entitled to receive welfare aid, the taxpayer requested assistance from the union. In keeping with its policy of aiding both members and non-members in need, the union supplied food vouchers worth six dollars a week and nine dollars cash per week for rent. He was not required to picket but did so anyway. In a refund suit, a jury found that the union's assistance constituted a gift, but judgment notwithstanding the verdict was entered for the government on the ground that the assistance was income as a matter of law. The Court of Appeals for the Seventh Circuit reversed and reinstated the jury verdict.⁹

Decisions in these three cases were handed down by the Supreme Court on the same day, and in each case the decision was based upon a

⁵ *Duberstein v. Commissioner*, 265 F.2d 28 (6th Cir. 1959). The court reasoned that the taxpayer had met his burden of proof that the payment was intended as a gift and not taxable compensation.

⁶ 363 U.S. 278 (1960).

⁷ *Stanton v. United States*, 268 F.2d 727 (2d Cir. 1959). The court reasoned that the taxpayer had not met the burden of proving that the commissioner was wrong in his determination that the payment was taxable compensation.

⁸ 363 U.S. 299 (1960).

⁹ *Kaiser v. United States*, 262 F.2d 367 (7th Cir. 1958). The court reasoned that the payments were consistent with charity and thus constituted a gift and not taxable compensation.

concept of limited appellate review. The Court completely avoided a decision on the merits of the cases which would have helped to clarify the gift versus compensation issue. The Court pointed out that the trier of fact, being closer to the situation, could more properly decide the issue, and, where the trial is by a judge sitting without a jury, reversal should follow if, but only if, the decision is "clearly erroneous." But where there is a jury trial under proper instruction, the only determination to be made on appeal concerning this issue is whether the verdict can be supported on the evidence. This limitation would not, however, obviate appellate review upon other grounds.

In the *Duberstein* case the Court held that the Tax Court's finding for the Commissioner was not "clearly erroneous" and reversed the court of appeals. In the *Stanton* case the Court found that the district court's finding of a gift was so "sparse and conclusory" that it afforded no revelation of that court's concept of the determining facts and legal standard. Judgment of the court of appeals was vacated and the case remanded to the district court.¹⁰

In the *Kaiser* case it was found that the jury had been properly instructed and that there was evidence to support its decision for the taxpayer. The court of appeals' judgment was affirmed.

The Government had requested the Court to promulgate a new test to serve as a uniform standard for determination of what constitutes a gift, namely that gifts should be defined as transfers of property made for personal as distinguished from business reasons.¹¹ The Court unequivocally rejected this test, feeling that the varying fact situations of such cases render it impossible to apply a uniform standard and that the trier of fact, being closer to the situation, can apply its "experience with the mainspring of human conduct" to all the factors and determine when a transfer amounts to a gift. The Court also said that if a test was desirable, Congress was the proper body to establish one by an amendment to the code, as was done in the case of prizes and awards.¹² The Court then left the issue of gift versus compensation to be decided on a case-by-case basis.

In previous decisions dealing with gifts the Supreme Court has laid down some broad rules of thumb, and a review of them will indicate something of the rationale used by the Court in deciding cases involving this issue.

¹⁰ *Stanton v. United States*, 186 F. Supp. 393 (E.D.N.Y. 1960). Upon retrial the district court judge found that the payment was a gift stating that the evidence showed that it was the employer's intention to make a gift.

¹¹ *Commissioner v. Duberstein*, 363 U.S. 278, 284 n.6 (1960).

¹² INT. REV. CODE OF 1954, § 74. This section, new in the 1954 code, removed prizes and awards from the gift versus compensation question and established separate tests for determination of the tax consequence upon receipt of a prize or award.

(1) Since the Internal Revenue Code definitely distinguishes between compensation on the one hand and gifts on the other, these terms are and were meant to be mutually exclusive. A transfer cannot be both a gift and a payment of compensation.¹³

(2) "Gifts" is a generic word of broad connotation which derives its meaning from the particular statute. In the Internal Revenue Code, it denotes the gratuitous receipt of financial advantages.¹⁴

(3) The payment for services, even though voluntary, is nevertheless compensation within the tax statute. The form of the payment is immaterial as is the fact that it may not be paid directly to the taxpayer.¹⁵

(4) If the payments to the employees of a business enterprise are made by persons interested in its success or the maintenance of the employee's good will and loyalty, there is an *inference* that the payments are intended as compensation.¹⁶

(5) The *lack* of any constraining force of a moral or legal duty or the lack of the incentive of any anticipated benefit other than the satisfaction which flows from the performance of a generous act is important but not determinative.¹⁷

(6) A gift is nonetheless a gift because inspired by gratitude for past faithful service of the recipient where it amounts to nothing more than the acknowledgment of an historical fact as a reason for making the gift.¹⁸

(7) The discharge of a legal obligation to make the payments for services rendered is in no sense a gift and it is irrelevant that the payor derives no economic benefit from these transfers.¹⁹

¹³ *Bogardus v. Commissioner*, 302 U.S. 34, 39 (1937) (dictum). The payments were made by a corporation to employees of a predecessor corporation who were not retained in the employment of the new corporation. The payments were held to be gifts to the employees.

¹⁴ *Helvering v. American Dental Co.*, 318 U.S. 322, 330 (1943) (dictum). Partial forgiveness of back rent and cancellation of accrued interest on notes did not create taxable income to the debtor taxpayer when the forgiveness was found to be gratuitous. *But see Commissioner v. Jacobson*, 336 U.S. 28 (1949).

¹⁵ *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730 (1929) (dictum). Voluntary payment by the employer of the income taxes assessable against the employee constituted additional taxable income to such employee. For payments of property other than money see *Commissioner v. Lo Bue*, 351 U.S. 243 (1956), involving stock options and *Neville v. Brodrick*, 235 F.2d 263 (10th Cir. 1956), involving transfers of stock.

¹⁶ *Bogardus v. Commissioner*, 302 U.S. 34, 41 (1937) (dictum).

¹⁷ *Ibid.*

¹⁸ *Id.* at 44.

¹⁹ *Robertson v. United States*, 343 U.S. 711 (1952) (dictum). "In the legal sense payment of a prize to a winner of a contest is the discharge of a contractual obligation. The acceptance by the contestants of the offer . . . creates an enforceable contract. The discharge of legal obligations—the payment for services rendered or consideration paid pursuant to a contract—is in no sense a gift." *Id.* at 713.

(8) Payments to an employee by an employer to secure better services are plainly compensation.²⁰

(9) "A gift in the statutory sense . . . proceeds from a 'detached and disinterested generosity' . . . 'out of affection, respect, admiration, charity or like impulses' And in this regard, the most critical consideration . . . is the transferor's 'intention' 'What controls is the intention with which payment, however voluntary, has been made.'"²¹

Applying these rules of thumb to the facts in the *Duberstein*, *Stanton* and *Kaiser* cases, there does not appear to be any way to question the conclusions of the respective triers of fact. That is not to say, however, that the conclusion would find universal acceptance, for these cases are close to the line and could have been decided either way. The Court seems to imply that it would have affirmed the decisions of the trier of fact even if these cases had been decided conversely in the first instance.

While decisions of the lower courts and the Tax Court in this area have been limited to the particular facts in each individual case, it is possible to indicate what elements of several basic situations have been more or less determinative in these decisions.²² The cases from these courts fall into these categories: formal employer-employee relationships; reorganizations and sales of business; payments upon retirement; death benefits to the employee's family or estate; and informal business relationships.

In a formal employer-employee relationship, the payments are usually made pursuant to the employment contract. Such payments are compensation for services rendered even though no service is ever performed.²³ Additional payments above the employee's basic salary or wage are regarded as compensation as long as they bear a fixed relationship to the employee's length of service and present salary.²⁴ It does not matter what designation the employer has given these additional payments²⁵ or that the employer does not take a deduction for tax purposes.²⁶ The relationship is an indication that the payments were meant

²⁰ *Commissioner v. Lo Bue*, 351 U.S. 243, 247 (1956) (dictum). Here there was a stock option plan with an arrangement whereby an employer transferred valuable consideration to his employee for services. The employee taxpayer realized taxable gain upon exercising the option. Special treatment is given to employee stock option under section 421 of the 1954 code where, if the plan qualifies, the tax consequences will be different from that in the *Lo Bue* case.

²¹ *Commissioner v. Duberstein*, 363 U.S. 278, 285-86 (1960) (dictum).

²² This is not intended to be an exhaustive review of all cases in this area.

²³ *George B. Lester*, 19 B.T.A. 549 (1930). *Contra*, *Estate of David R. Daly*, 3 B.T.A. 1042 (1926).

²⁴ *Painter v. Campbell*, 110 F. Supp. 503 (N.D. Tex. 1953); *N. H. Van Sicklen, Jr.*, 33 B.T.A. 544 (1935).

²⁵ *Wallace v. Commissioner*, 219 F.2d 855 (5th Cir. 1955); *Thomas v. Commissioner*, 135 F.2d 378 (5th Cir. 1943). *Contra*, *Blair v. Rosseter*, 33 F.2d 286 (9th Cir. 1929).

²⁶ *Thomas v. Commissioner*, *supra* note 25.

as compensation; and where it is absent, the court has held the payment to be a gift.²⁷ The one exception appears to be in the case of articles of small value given on special occasions where there arises a justifiable inference of gift. Thus the treasury has recently ruled that things of nominal value given by an employer to his employees at Christmas can be gifts even though they are used to promote good will and are deducted as business expenses.²⁸ But a wedding gift, in recognition of service, has been held to be compensation.²⁹ It would seem that wherever payments are made by an employer to his employee it is extremely doubtful that they can be treated as gifts, for it will be difficult, if not impossible, to rebut the presumption that the payments are intended as compensation for services, either past or future. An employer is in business for profit, not philanthropy, the courts seem to say.

Key employees often receive additional payments when a business is sold or undergoes reorganization. These payments are considered compensation where they bear a relationship to the length of service and previous salary scale³⁰ or where the transferor deducted them for tax purposes.³¹ The theory is that the payments were intended as additional compensation for past services, and a deduction by the employer is treated as strong evidence of this intention. This inference has even attached to payments made to an employee when he resigned voluntarily.³² Such an inference may be overcome only in very special circumstances. Where the payments were voted by the stockholders of the successor corporation, they have been treated as gifts on the theory that moral and legal obligation is lacking; and it did not matter that the stockholders of the successor corporation were essentially the same as those of the old corporation.³³

Extra payments to employees at the time of their retirement, in recognition of their long and faithful service, have been held to be compensation for past services, especially where the employer takes a deduction in his return.³⁴ The reason for the employee's retirement does not matter.³⁵ There is, however, an exception in favor of clergymen who receive such payments in excess of contract provisions upon retirement, these being considered tokens of gratitude and appreciation

²⁷ *Hoefle v. Commissioner*, 114 F.2d 713 (6th Cir. 1940).

²⁸ Rev. Rul. 59-58, 1959-1 CUM. BULL. 17.

²⁹ *Nickelsburg v. Commissioner*, 154 F.2d 70 (2d Cir. 1946).

³⁰ *Carragan v. Commissioner*, 197 F.2d 246. (2d Cir. 1952); *Poorman v. Commissioner*, 131 F.2d 946 (9th Cir. 1942).

³¹ *Chauncey L. Landon*, 16 B.T.A. 907 (1929).

³² See *Noel v. Parrott*, 15 F.2d 669 (4th Cir. 1926). *Contra*, *Cunningham v. Commissioner*, 67 F.2d 205 (3d Cir. 1933).

³³ *Hall v. Commissioner*, 93 F.2d 1005 (4th Cir. 1938).

³⁴ *Willkie v. Commissioner*, 127 F.2d 953 (6th Cir. 1942); *Fisher v. Commissioner*, 59 F.2d 192 (2d Cir. 1932).

³⁵ *Ruth Jackson*, 25 T.C. 1106 (1956); *L. Gordon Walker*, 25 T.C. 832 (1956).

and consequently gifts.³⁶ Under similar circumstances, the retirement benefits of an officer of a non-profit organization have been treated as a gift.³⁷ In summary it seems that an employee of a profit making organization as opposed to a non-profit or tax-exempt one will have difficulty successfully claiming that additional payments received due to reorganization, sale or retirement were gifts. The profit motive of business does not allow for much charity, and the inference that these were payments for past services as well as the evidence of the employer's deduction will be difficult to overcome. A non-profit organization, the courts imply, is more likely to have motives of charity.

Death benefits paid by an employer to the employee's family are compensation when paid pursuant to the employment contract³⁸ or where the payments are made as a general practice so as to become a moral obligation.³⁹ But if the benefits are entirely voluntary and the beneficiary has rendered no service, they can be considered gifts regardless of whether the employer has taken a deduction for the payments in his return.⁴⁰ Payments to the employee's estate are treated in the same way as payments to the family.⁴¹ For 1954 and later years, section 101(b) of the 1954 Code will affect the taxation of these benefits. Under this section, up to \$5,000 may be paid to the beneficiaries of a deceased employee free of income tax. Nothing in the way of a contract or plan is required to achieve this tax free status. But if the payments are gifts, they are not subject to the provisions of this section and are entirely excluded from taxation.⁴²

The discussion of the lower court decisions up to this point has dealt with the formal employer-employee situation. There are also problems where this relationship does not exist. In this area the principle factor in determining the question of gift or compensation is whether the payments were made in a business context. Token payments received for friendly services, such as non-professional investment advice,⁴³ endorsement of a note,⁴⁴ and voluntary legal services⁴⁵ have been held to be gifts. But where the payment was given to the taxpayer as

³⁶ *Abernethy v. Commissioner*, 211 F.2d 651 (D.C. Cir. 1954); *Mutch v. Commissioner*, 209 F.2d 390 (3d Cir. 1954); *Schall v. Commissioner*, 174 F.2d 893 (5th Cir. 1949).

³⁷ *Adams v. Riordan*, 57-2 U.S. Tax. Cas. ¶ 9770 (D. Vt. 1957).

³⁸ *Flarsheim v. United States*, 156 F.2d 105 (8th Cir. 1946).

³⁹ *Simpson v. United States*, 261 F.2d 497 (7th Cir. 1958).

⁴⁰ *United States v. Kasynski*, 284 F.2d 143 (10th Cir. 1960); *United States v. Allinger*, 275 F.2d 421 (6th Cir. 1960); *Bounds v. United States*, 262 F.2d 876 (4th Cir. 1958). *Contra*, *Estate of Mervin G. Pierpont*, 35 T.C. No. 10 (1960).

⁴¹ *Bausch's Estate v. Commissioner*, 186 F.2d 313 (2d Cir. 1951); *Estate of Frank J. Foote*, 28 T.C. 547 (1957).

⁴² *United States v. Reed*, 277 F.2d 456 (6th Cir. 1960).

⁴³ *Estate of Grace G. McAdow*, 12 T.C. 311 (1949).

⁴⁴ *Dupuy G. Warrick*, 44 B.T.A. 1068 (1941).

⁴⁵ *J. Marion Wright*, 30 T.C. 392 (1958).

consideration for aid in furthering the business for the transferor and the payment bears a relationship to the value of the service rendered, it has been held to be compensation for services.⁴⁶ Also where the payment was to a taxpayer for services in arranging a business transaction between other individuals, and the transferor is one of these individuals, the payment is held to be compensation for services.⁴⁷ Tips⁴⁸ and rewards for special services⁴⁹ are payment for services. Legal fees shared by lawyers for handling a case are held to be compensation.⁵⁰ As might be expected, an allowance to a wife by her husband for acting as a housewife was not income for tax purposes.⁵¹ In short, if there is a business connotation in the service and the payment bears a relationship to the value of the service, the payment is very likely to be classified as compensation.

In conclusion it can only be reiterated that there are no clearly defined meanings for the terms "gifts" and "compensation" as used in the Internal Revenue Code nor is it probable that they will ever be clearly defined.⁵² The Supreme Court in the principal cases did not attempt to resolve the definitional problems. As a result, there is no clear cut course for the taxpayer to follow, no precise rule for the tax lawyer to apply. If, a transfer of money or other property is contemplated, and a gift is intended, there are several precautions the observance of which might insure the completion of a gift and not the creation of taxable compensation within the meaning of the Internal Revenue Code. (1) The term "gift" should be used and such terms as "bonus," "salary," and "honorarium" should be avoided in any formal letters or resolutions concerning the payment. (2) References to any services which the donee might have rendered should be avoided. (3) If the transferor is a corporation, the transfer should be ratified by the stockholders. (4) The use of a salary schedule and length of service should be avoided when deciding upon the amount of payment. (5) The use of any reference to possible future payment or to a general practice of making such payments should be avoided. (6) A deduction for tax purposes for these payments should not be taken.

FRANCIS N. MILLETT, JR.

⁴⁶ Alford J. Williams, Jr., 29 B.T.A. 892 (1934).

⁴⁷ Lundsford v. Commissioner, 62 F.2d 740 (6th Cir. 1933).

⁴⁸ Roberts v. Commissioner, 176 F.2d 221 (9th Cir. 1949).

⁴⁹ O.D. 602, 3 CUM. BULL. 93 (1920). Reward for the prevention of a bank robbery was held to be compensation.

⁵⁰ Mertz v. Hickey, 162 F.2d 403 (2d Cir. 1947); Friedman v. Commissioner, 130 F.2d 305 (4th Cir. 1942).

⁵¹ Rosa E. Burkhart, 11 B.T.A. 275 (1928).

⁵² Such lack of clear definition is also evident in other areas of income tax, for example, the problem of "interest versus dividends." See John Kelly Co. v. Commissioner, 326 U.S. 521 (1946).