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DEFERRED COMPENSATION—QUALIFIED AND NONQUALIFIED: A LEGISLATIVE PERSPECTIVE THROUGH THE TAX REFORM ACT OF 1969

Federal income tax statutes are inevitably accommodations to the stresses of powerful and often conflicting economic forces. As a result the statutes are complex, never perfect, always incomplete, and sometimes even useful and appropriate for the matters in issue. Those provisions of the 1969 Tax Reform Act relating to deferred compensation, special H.R. 10 plans, and standard corporate qualified retirement plans, do not constitute exceptions to the general rule. In some respects they typify the better aspects of the legislative drafting art; in other ways they contain serious drawbacks. The following article considers the manner in which these deferred compensation and associated provisions reflect the gestational pressures. It also seeks to evaluate the tendencies of the provisions to enhance or detract from the Internal Revenue Code's function as a constitutional, rational, and pragmatically adaptable economic tool.

GERALD H. SHERMAN*

The interests of clarity and orderliness would normally require that this article begin with a definition of the subject with which it purports to deal. Following this rule, the commonly understood term, deferred compensation, seems a rather simple matter. Unhappily, the task, when faced squarely, is a formidable, perhaps impossible, one. Even the Assistant Secretary of the Treasury for Tax Policy had to concede that his department with its considerable resources has been unable "to develop a satisfactory definition of the term."¹ Accepting the Assistant Secretary's confession as an accurate prediction of the success others might have in a similar endeavor, this article begins by merely setting down the kinds of arrangements which tax practitioners usually view as deferred compensation. This more manageable task will be accompanied

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1. *Statement of Assistant Secretary of the Treasury Edwin S. Cohen*, in THE PRESIDENTS TAX REFORM PROPOSALS 52 (Comm. Print of the House Ways and Means Comm., 91st Cong., 1st Sess. 1969).

by an evaluation of the ways in which the Tax Reform Act of 1969² has attempted to change the rules applicable to these kinds of arrangements.

TYPES OF DEFERRED COMPENSATION

The Internal Revenue Code for many years has maintained a series of technical rules that have as their purpose the delineation of a type of compensation for services rendered which receives special and beneficial tax treatment.³ Qualified retirement plans, the natural outgrowth of these rules, constitute one of the most tax-favored forms of deferred compensation. These plans generally consist of pension and profit sharing arrangements⁴ by which an employer receives a deduction for contributions to a special fund.⁵ The fund, along with its earnings which are permitted to accumulate tax free,⁶ is held for distribution at some future time (e.g., retirement) to beneficiaries (normally the employees who earned the compensation by the rendering of service). The beneficiaries are subject to tax on the distributions at the time of receipt.⁷ The contributions to the fund are not taxable income to the employee at the time they are made.

The full scope of the tax benefit applies to qualified retirement plans of corporate employers and noncorporate employers in cases where no self-employed person is covered under the plan. Somewhat lesser benefits are available in the case of plans to be utilized by noncorporate entities involving self-employed persons. Here we have the special H.R. 10 or Keogh Act rules.⁸

In the 1969 Act, no effort was made to amend the H.R. 10 rules. Rather there was an attempt to equate corporate plans of subchapter S corporations with the H.R. 10 approach.⁹ In the case of corporate plans

2. 83 Stat. 487. In bill form, before passage, the Act was identified as H.R. 13270, 91st Cong., 1st Sess. (1969).

3. INT. REV. CODE OF 1954, §§ 401-07.

4. Stock bonus and annuity plans are also included. *Id.* §§ 403, 421-25.

5. *Id.* § 404.

6. *Id.* § 501(a).

7. *Id.* §§ 402, 403.

8. The rules were passed as Self-Employed Individuals Tax Retirement Act of 1962, 76 STAT. 809, after more than a decade of consideration by Congress and hard lobbying efforts by proponents. The Keogh Act takes its name from its prime sponsor, then Congressman Eugene Keogh of New York.

9. Tax Reform Act of 1969, tit. V, § 531(a), 83 Stat. 654 (codified at INT. REV. CODE OF 1954, § 1379).

generally, the 1969 Act purported to make a change only in the area of the capital gain treatment of lump sum distributions to beneficiaries.¹⁰

Over the years, commentators have pointed to the deficiencies in the conception and operation of corporate plans. The most comprehensive statement of these deficiencies appears in the 1965 report of the special President's Committee.¹¹

The 1969 Act did not purport to impose sweeping qualified plan reforms. Alternatively, Secretary Cohen indicated that the Treasury was making a comprehensive study of these plans and that recommendations to the Congress would soon be forthcoming.¹² These recommendations are expected during 1970, but have not been released to the public at the time of this writing.

All funded deferred compensation arrangements do not constitute qualified retirement plans; however, even a nonqualified funded deferred compensation arrangement may receive beneficial tax treatment, although, the benefits are less than those applicable to qualified arrangements. If carefully constructed a nonqualified funded arrangement, while it may not result in an immediate tax deduction to the employer nor in tax free accumulation of the fund's income, can result in the deferral of the recognition of income by the employee-beneficiary until such time as he receives compensation benefits.¹³ The 1969 Act makes substantial changes in the rules applicable to nonqualified funded deferred compensation. This article will examine these changes in detail.

There is a type of deferred compensation which is not supported by a special funding arrangement but is a reflection of purely contractual agreements between employer and employee. In effect, the employee agrees to perform current services for compensation paid, at least in part, at a future time. No special fund is put aside for him nor is he provided with rights superior to those of other creditors. There is usually no reason for the employee's agreement to such an arrangement other than the desire to reduce taxes. The receipt and recognition of income is moved from presumably higher bracket earning years to lower bracket retirement years. Under normally applied rules the employer receives

10. *Id.* § 515.

11. PRESIDENT'S COMMITTEE ON CORPORATE PENSION FUNDS AND OTHER PRIVATE RETIREMENT AND WELFARE PROGRAMS, PUBLIC POLICY AND PRIVATE PENSION PROGRAMS (1965).

12. *Statement of Assistant Secretary of the Treasury Edwin S. Cohen, supra* note 1, at 52-53.

13. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174. See INT. REV. CODE OF 1954, § 404(a)(5) for rules respecting the employer's deduction.

a deduction at the time of the payment of the compensation, *i.e.*, at the same time the employee recognizes income.¹⁴

A number of policy questions are inevitably raised with respect to this kind of arrangement. As an initial matter, should the Revenue Code countenance a deferral of income of this nature solely for the sake of tax leverage or should there be a requirement for some underlying non-tax motivation? Lesser questions concern the technical adequacy of the rules for nonqualified unfunded deferred compensation and the relationship of those rules to the rules for nonqualified funded deferred compensation. These issues were raised during the Congressional consideration of the 1969 Act. The answers, however, like the compensation, were deferred.

It is these kinds of deferred compensation which will be considered in this article: (1) qualified retirement plans, (2) nonqualified funded arrangements, and (3) nonqualified unfunded contractual arrangements. In addition, this study will discuss restricted property which can be viewed as a form of a nonqualified funded arrangement. Although there are other kinds of situations which, if one chose, could be included within the deferred compensation category, they are specifically excluded here. For example, various kinds of statutory and nonstatutory stock options can be thought of as deferred compensation.¹⁵ Similarly, deferred payments of certain kinds of employee fringe benefits could come within the scope of the term.¹⁶ For the purpose here, however, they will be omitted.

QUALITATIVELY LEGISLATIVE STANDARDS

If one is to evaluate the legislative efforts directed toward deferred compensation in the 1969 Act he should set standards by which to make the evaluation. One could establish as many standards as there are minds engaged in the establishing of such standards. We will eliminate a number of possible approaches by not making evaluations based on social policy. We will assume that the policy reasons supporting each of the provisions under examination here are compelling and will not attempt to make judgments on the value of those reasons.

We will also put aside issues of revenue raising. Such considerations

14. *Id.*

15. INT. REV. CODE OF 1954, §§ 421-25; Treas. Reg. § 1.421-6 (1966).

16. *E.g.*, accrued vacation pay. See Tax Reform Act of 1969, tit. IX, § 903, 83 Stat. 711 (amending Technical Amendments Act of 1958, § 97, 72 Stat. 1672).

are always pertinent to a tax bill. Realistically, however, they are more in the domains of the economist and politician than the lawyer.

We can then set five standards which, in the view of the author, are rather commonly applied to tax legislation. Not all of these standards will be relevant to each provision of the 1969 Act that is examined, but at least one should be pertinent to every such aspect.

1. The legislation should be constitutional. This usually presents little difficulty in the case of tax statutes since the courts have been zealous in upholding their constitutionality against almost all challenges. In fact, Mertens¹⁷ indicates that in only one instance have the courts struck down such a statute as unconstitutional.¹⁸ The constitutionality of at least one facet of deferred compensation will prove to be pertinent, however, and will be discussed.

2. To the extent possible the language of the statute and the rules resulting therefrom should be simple and capable of being understood by as many persons as possible. Such a standard of evaluation is probably more in the nature of a dream than an attainable, practical goal. Complexity and tax statutes are seemingly inseparable. George E. Holmes, in the preface to his 1920 treatise, *Federal Income and Profits Taxes*, discussed the imminence of changes in the federal taxing structure, then only seven years old.¹⁹ He said those changes were imminent for two reasons, one of which he described in this fashion: "The complexities of the present system involve too much administrative labor—simplification is necessary if the tax is to be collected promptly and at low cost. Attention should, and will be, directed towards the solution of this problem."²⁰ Fifty years later the same complaints are being made of our taxing system, with the same sense of moral indignation and with the same likelihood of success. The search for simplicity, however, is a worthy one and should not be abandoned. Without simplicity as a constant goal the Internal Revenue Code would doubtless be even more incomprehensible and labyrinthian than it is today.

3. Like taxpayers and like situations should be subject to like rules of taxation. This standard is, we will all acknowledge, an important one, but perhaps best understood when viewed in tandem with the next criterion.

4. Rules, the consequences of which are thought to offend commonly

17. J. MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 4.01 (rev. ed. 1969).

18. *Eisner v. Macomber*, 252 U.S. 189 (1920).

19. The sixteenth amendment was ratified in 1913.

20. G. HOLMES, *FEDERAL INCOME AND PROFITS TAXES* iii (1920).

accepted standards of tax equity, should be quarantined, reduced, and, if possible, eliminated. The late Louis Eisenstein commented on the problems inherent in making this reconciliation.²¹ For example, he noted that Stanley Surrey²² has talked of provisions that "run counter to our notions of tax fairness." Eisenstein rightfully questions the employment of the word "our."²³ Such a Marcusian usage may have the unfortunate effect of camouflaging the complexities of the problem.

The difficulties posed by these conflicting standards were vividly demonstrated during the Senate debate on the 1969 Act. Senator Fannin of Arizona introduced an amendment, later approved by the Senate, for the purpose of deleting from the bill the limitations on the use of qualified plans by so-called professional service corporations.

Mr. Ribicoff. Under the Fannin proposal, which is now advocated by the Senator from Arizona we would have this tax gimmick prevail. It is not illegal. The Treasury Department has ruled it is proper.

Mr. Gore. Mr. President, the Treasury has lost case after case in the courts until they say they cannot contest it further.

Mr. Fannin. The Senator is saying that I advocate this. That is not so. The Senator is stretching the facts.

Mr. Ribicoff. I say the Senator is trying to permit it to remain as it is at the present time.

Mr. Fannin. Until we have hearings and treat everyone alike. I am just asking for the same treatment for a professional corporation that is given everyone else, other corporations. I am not asking for any special privileges.

Mr. Ribicoff. Not special privileges, but I am talking about the thrust of the Senator's proposal as against the thrust of the committee proposal and I am comparing them.

Mr. Fannin. The committee proposal is discriminating against one group.

Mr. Ribicoff. No, I do not think the committee proposal is discriminating against anybody. The committee proposal wants to

21. L. EISENSTEIN, *THE IDEOLOGIES OF TAXATION* (1961).

22. Currently Professor of Law at the Harvard Law School, formerly Assistant Secretary of the Treasury for Tax Policy.

23. L. EISENSTEIN, *supra* note 21, at 194-95.

plug a loophole before it spreads like wildfire, all through America.²⁴

Senator Fannin is the advocate of equality, the denier of special privileges and the propounder of uniform legislation. Senator Ribicoff is the intrepid plugger of loopholes. Exchanges of this nature are repeated throughout the *Congressional Record*. Each man states his moral position and neither man convinces the other. It is not so much a debate as an exercise in declamation.

The difficulties we will have in reconciling the conflicting standards can be readily anticipated and, hopefully, sympathetically understood.

5. The statute should be enacted, only after adequate public discussion. This is normally the case with tax legislation of general applicability.²⁵ Hearings before the tax statute writing committees, the House Ways and Means and the Senate Finance Committees, usually provide adequate opportunity for public discussion.

QUALIFIED RETIREMENT PLANS OF SUBCHAPTER S CORPORATIONS

Self-employed individuals²⁶ may become beneficiaries of qualified retirement plans. Such plans, however, are subject to a rather lengthy list of special limitations that are not applicable to plans, normally corporate plans, which do not benefit self-employed individuals. The primary restriction is the limit, on the annual deductibility of contributions by a self-employed individual, to the lesser of \$2500 or ten percent of the person's self-employment income.²⁷

The Self-Employed Individuals Tax Retirement Act²⁸ (more popularly known as H.R. 10 or the Keogh Act) which authorized retirement benefits for self-employed individuals was intended to "make self-employment somewhat more attractive, compared to employment with a corporation, and . . . thus help to keep small business strong and independent professional practice thriving."²⁹

Although seemingly not considered by Congress at the time of the

24. 115 CONG. REC. S16245 (daily ed. Dec. 8, 1969).

25. There are exceptions, of course, for private legislation which sometimes appears as legislation of general applicability. A prime example of this kind of situation is the famous or infamous Louis B. Mayer amendment which is described by L. EISENSTEIN, *supra* note 21, at 156-57.

26. As defined in INT. REV. CODE of 1954, § 401(c) (1), (2).

27. *Id.* § 404(e) (1).

28. 76 STAT. 809 (1962).

29. H.R. REP. NO. 378, 87th Cong., 1st Sess. 4 (1961).

enactment of H.R. 10, both small business and independent professional practice can often be operated in corporate form.³⁰ Further, the corporate form of operation can be made subject to income tax rules roughly equivalent to those pertinent to noncorporate operation; *i.e.*, by means of the pass-through approach of subchapter S, if elected, the stockholder-entrepreneur can be taxed directly on the income generated by the corporate form of the business or profession.³¹ If this corporate form of operation can be undertaken, then the entrepreneur, now technically a corporate employee and no longer self-employed, may be covered under a normal corporate qualified retirement plan. The plan and his interest in it will not be subject to the special limitations pertinent to the self-employed.

In recognition of this situation, section 531 of the 1969 Act³² attempts to convert subchapter S corporations from the application of normal corporate qualified retirement plan rules to the application of the H.R. 10 rules.³³

Your committee [the House Ways and Means Committee] believes that if an enterprise wants to incorporate for business purposes but wants to be taxed in a manner similar to a partnership, then it should be subject to the same H.R. 10 limitations as partnerships in the case of the tax treatment of pension plans.³⁴

The adequacy of section 531 as a reflection of this legislative purpose is subject to some question.

As stated above, self-employed persons are faced with an annual limit on deductible contributions of \$2500 or ten percent of self-employed

30. Within the past ten years (for the most part after the passage of H.R. 10) most states have passed professional service corporation statutes by which professionals, such as doctors and dentists, may practice in corporate form. See Rev. Rul. 70-101, 1970-9, INT. REV. BULL. No. 13 for a list of those statutes. Only New York, Iowa, Wyoming, and the District of Columbia do not have such statutes.

31. See INT. REV. CODE of 1954, §§ 1371-78.

32. Tax Reform Act of 1969, tit. V, § 531, 83 Stat. 655 (codified at INT. REV. CODE of 1954, § 1379).

33. The provision applies only to corporate taxable years beginning after December 31, 1970. *Id.*

34. H.R. REP. No. 91-413, pt. 1, 91st Cong., 1st Sess. 170 (1969). The Ways and Means Committee initially placed the problem on its agenda in the following language: Should the treatment of subchapter S corporations "be modified . . . to limit retirement benefits for employer-shareholders in the same manner as the case of self-employed persons generally." Ways and Means Committee Press Release of January 29, 1969, paragraph XIII(5).

income, whichever is lesser. The 1969 Act's equalizing provision requires that contributions to qualified retirement plans by subchapter S corporations in excess of that annual limitation for each stockholder-employee³⁵ will be included in the stockholder-employee's taxable income.³⁶ This effectively cancels the tax benefit effect, with respect to the excess of the pass-through deduction under subchapter S. In contrast to the strictures of the H.R. 10 rules, however, qualified plans of subchapter S corporations may continue the tax-free accumulation of the earnings on the excess contributions.³⁷ Under H.R. 10 rules, such excess contributions must be distributed to self-employed individuals who have a ten percent or greater interest in the capital or profits of the business.³⁸ As a consequence, the tax-free accumulation possibility on the excess is eliminated. No explanation is provided for the maintenance of this distinction which is clearly beneficial to subchapter S corporations and tends to defeat the equalizing aim of the statute.

Another special H.R. 10 provision relates to the treatment of forfeitures. Under H.R. 10 all contributions on behalf of employees must be fully vested when made if at least one of the participants in the plan is a self-employed individual who has a ten percent or greater interest in the capital or profits of the business.³⁹ In effect, there are no opportunities for forfeitures. In coordination with this approach the 1969 Act precludes forfeitures for the benefit of stockholder-employees.⁴⁰ There is no restriction, however, on the forfeitures that can benefit employees other than stockholder-employees. The imperfection of the matching between H.R. 10 plans and subchapter S plans is, thus, apparent.

After having drawn these close distinctions, the utility of which is questionable, the 1969 Act does not attempt further to equate H.R. 10 rules and subchapter S rules. The legislative history offers no reason why the following H.R. 10 provisions, if there is validity to the basic assumption upon which the 1969's Act's section 531 is premised, should not be applied to all subchapter S plans:

35. "Stockholder-employee" is defined in the statute as an employee who owns five percent of the outstanding stock. INT. REV. CODE OF 1954, § 1379(d). The ten percent of self-employed income is changed to ten percent of compensation. *Id.* § 1379(b) (1) (A).

36. *Id.* § 1379(b).

37. *Id.* See § 501(a).

38. *Id.* § 401(d) (8). These ten percent self-employed individuals are designated "owner-employees." *Id.* § 401(c) (3).

39. *Id.* § 401(d) (2) (A).

40. *Id.* § 1379(a).

1. Required age 70- $\frac{1}{2}$ for distributions.⁴¹
2. Requirement of bank or insurance company as trustee.⁴²
3. Required contribution formula for profit sharing plans.⁴³
4. Maximum three-year employment requirement.⁴⁴
5. No distribution to entrepreneur prior to age 59- $\frac{1}{2}$.⁴⁵
6. Limit on excess contributions by the entrepreneur.⁴⁶
7. Special coordination of Social Security contributions.⁴⁷
8. Limitations on the ways in which distributions can be made after the death of the employee.⁴⁸
9. Coordination of participation by owner-employee in two or more unincorporated businesses.⁴⁹
10. No possibility of capital gain treatment on lump sum distributions.⁵⁰

The failure to apply the above limitations to subchapter S situations constitutes, of course, a failure to treat like situations equally. Concededly, it would not be without merit to argue that the application of such limitations is not worth the statutory complexity required for implementation. The basic worth of the limitation might also be questioned. Furthermore, it could be argued that the participation of a stockholder-employee in a corporate plan should not cause remaining employee-participants to be treated differently than employee-participants in other corporate plans. Of course, the same plea can be made with respect to nonself-employed participants in H.R. 10 plans.

41. *Id.* § 401(a) (9).

42. *Id.* § 401(d) (1).

43. *Id.* § 401(d) (2) (R).

44. *Id.* § 401(d) (3).

45. *Id.* § 401(d) (4) (B).

46. *Id.* § 401(d) (5), (8), 401(e).

47. *Id.* § 401(d) (6).

48. *Id.* § 401(d) (7).

49. *Id.* §§ 401(d) (9), (10). The failure to coordinate participation by the same person as a self-employed beneficiary of an H.R. 10 plan and as a stockholder-employee beneficiary of a subchapter S plan could lead to some abuse where, for example, a doctor undertakes part of his practice in noncorporate form and part in corporate form. He might be able to generate \$5000 of contribution deductions in one year, \$2500 under each plan. Another alternative would be to be employed by and attain coverage under the plans of more than one subchapter S corporation.

50. See the text accompanying notes 59-79 *infra*, respecting the limited availability of capital gains treatment to recipients of certain lump sum distributions from corporate plans, as contrasted to the complete unavailability of such treatment for noncorporate plan recipients who are self-employed individuals for H.R. 10 purposes. Consequently, stockholder-employees may continue to benefit from the capital gain possibility, whereas no such benefit may accrue for self-employed individuals.

After simply ignoring this sizable group of intricate limitations, Congress made a special effort to close a statutory breach, the possible use of which may be more apparent than real. In section 404(a)(3)(A),⁵¹ the meaning of which is so obscure that one must rely on the regulations for an understandable interpretation,⁵² a carryforward to future years is permitted of (1) unused deductions for qualified profit sharing plan contributions that could have been, but were not, made (*i.e.*, the difference between the lesser amount deducted each year and the maximum permissible fifteen percent of compensation deduction)⁵³ and (2) excess qualified profit sharing plan contribution deductions (*i.e.*, the difference between the greater amount contributed each year and the limiting fifteen percent of compensation deduction).⁵⁴ The possible breach in the statute concerns the first item, the carryforward of unused deductions.

Unless the breach is closed, the ten percent of compensation limit for a stockholder-employee during the years when a subchapter S election is in effect can be effectively avoided. To wit, in subsequent years when the subchapter S election is terminated, deductible contributions on behalf of the stockholder-employee could be fifteen percent of compensation for those years plus an otherwise nondeductible amount equal to five percent of the stockholder-employee's compensation for the subchapter S years (fifteen percent minus ten percent of compensation for those years). This "loophole" is "plugged" by newly enacted section 1379(c).

Given the technical virtuosity with which the statutory mending was accomplished, one wonders why the carryforward of unused contributions deductions was eliminated for all employees of subchapter S corporations and not merely stockholder-employees, the only class of persons who could undesirably benefit from the existence of the carryforward. The answer doubtless lies, at least in part, in the fact that the statute has become so complex that it has, with respect to certain of its provisions, become the embodiment of uncontrolled technology. It has become the science fiction robot that assumes command of its human creator. Given the time limitations within which the 1969 Act was produced, it may be impossible for a legislative draftsman or a tax tech-

51. INT. REV. CODE OF 1954, § 404(a)(3)(A).

52. TREAS. REG. § 1.404(a)-9 (1961).

53. See the second sentence of INT. REV. CODE OF 1954, § 404(a)(3)(A). The basic fifteen percent of compensation appears in the first sentence of the section.

54. See the third sentence of *id.* § 404(a)(3)(A).

nician, no matter how broad his knowledge or precise his skill, to generate a complete mastery of the statute's technical features. When this point is reached, the complex statute is understood by neither the taxpayer, his tax advisor, nor the examining Revenue Agent. As a consequence, the statute becomes a much simpler and more practical implement than its intricate structure would warrant. The offending portions of the statute are either ignored or interpreted in practice in a manner that seems sensible and operable to the people who work with it. Ignorance of the law may not only be an acceptable excuse in the case of the Internal Revenue Code, it may be indispensable.

Another provision in the subchapter S tangle illustrates the hatchet approach to tax equity or "half a loaf is just enough." Under H.R. 10, the limitation on deductible contributions applies to all self-employed persons. Most of the more severe restrictions and penalties, however, apply to owner-employees, *i.e.*, ten percent owners. When the subchapter S amendment was proposed by the Treasury Department under both Democratic and Republican Administrations,⁵⁵ the limitation on deductible contributions was intended to apply to a ten percent stockholder-employee for whom most of the H.R. 10 limitations would have been pertinent if he were self-employed. It was not intended to apply to a less than ten percent stockholder-employee. The House Ways and Means Committee, the full House of Representatives, and the Senate Finance Committee, however, each without statement of the reason, propounded an approach by which the deduction limitation was to apply to a five percent stockholder-employee.⁵⁶

Since there is no statement in the record of a supporting reason for this change, one can only assume that a compromise between zero and ten percent was being effected. When the bill reached the Senate floor, however, Senator Mathias of Maryland pointed to the existence of the ten percent equity test for H.R. 10 purposes and asked that the new subchapter S limitations be applied only to ten percent stockholder-employees.⁵⁷ Unfortunately, Senator Mathias failed to develop for the

55. The Proposal of the Democratic Administration appeared in U.S. TREASURY DEPARTMENT, TAX REFORM STUDIES AND PROPOSALS 41 (Comm. Print of the Joint Publication Comm. of the House Ways and Means Comm. and the Senate Finance Comm., 91st Cong., 1st Sess. 1969). The proposal of the Republican Administration appeared in Technical Explanation of Treasury Tax Reform Proposals, *supra*, note 1, at 304.

56. Although the subchapter S provision was passed as the Tax Reform Act of 1969, tit. V, § 531, 83 Stat. 654, it appeared in H.R. 13270, 91st Cong., 1st Sess. § 541, when reported by the House Ways and Means Committee.

57. Amend. No. 382, 115 CONG. REC. S16237-40 (daily ed. Dec. 9, 1969).

Senate the niceties of the distinction between a self-employed person of any percentage of ownership (including less than ten percent owners), for whom the deduction limitation under H.R. 10 applies, and the ten percent owner-employee who is burdened with the additional, more severe restrictions. If he had been more accurate in his description, it is conceivable that the Senate would have accepted the Finance Committee's five percent compromise version, but without the benefit of such precise explanation, the Senate approved Mr. Mathias' amendment and sent to Conference a bill which would have applied only to ten percent stockholder-employees. The Conference Committee promptly, but without explanation, reset the limitation at five percent.⁵⁸

Perhaps new section 1379 will accomplish its purpose of developing practical parity between H.R. 10 retirement plans and subchapter S retirement plans. If it does, it will not be because the statute clearly develops such an equality; it will be because the simplicity of the concept has managed to resist the complexity and sometimes capricious effect of the statute.

LUMP SUM DISTRIBUTION

For many years, commentators⁵⁹ have been questioning the rule that permits certain lump sum distributions from qualified retirement plans to be taxed in the hands of the recipients at capital gain rates.⁶⁰ Until the 1969 Act, all efforts other than those with respect to H.R. 10, proved to be unsuccessful. Section 515 of the 1969 Act, which imposes limitations on the permissible capital gain treatment,⁶¹ did so only after a substantial struggle during the legislative process. The bill, as approved by the House, contained the basic lump sum distribution provisions that eventually found their way into the final version of the Act. Capital gain treatment was withdrawn for a substantial portion of such distribu-

58. H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 322 (1969).

59. See, e.g., Public Policy and Private Pension Programs, *supra* note 11.

60. The capital gain approach was initially utilized as a method of ameliorating the consequences of progressive rates on the receipt in a single year of "bunched income" that was earned over a number of years. See H.R. REP. NO. 91-413, *supra* note 34, at 154. A lump sum distribution to qualify for capital gain treatment must consist of "the total distributions payable with respect to any employee" and must be "paid to the distributee within 1 taxable year of the distribution on account of the employee's death or other separation from the service, or on account of the death of the employee after his separation from the service" of the employer. INT. REV. CODE OF 1954, § 402(a)(2). See also *Id.* § 403(a)(2).

61. Tax Reform Act of 1969, tit. V, § 515, 83 Stat. 643-46.

tions.⁶² The Senate Finance Committee, although it changed certain computational features, adopted the House version in essence.⁶³ The Senate, however, approved Senator Inouye's floor amendment which deleted the provision in its entirety.⁶⁴ The final chapter of this controversy was written by the Conference Committee which approved the House version.⁶⁵

Putting aside effective date provisions that clothe section 515 of the Act with only post-1969 prospective effect,⁶⁶ the new rule approves capital gain treatment for that portion of the lump sum distribution which reflects the tax free accumulation of earnings in the plan prior to distribution. The remaining portion of the distribution, in excess of the employee's basis for his interest in the plan, will be subject to tax at ordinary income rates after application, with certain limitations, of a constructive seven-year averaging formula.⁶⁷

The averaging formula is formalistically the same as that applicable to lump sum distributions for self-employed individuals under H.R. 10, except that a factor of seven is substituted for the H.R. 10 factor of five.⁶⁸ Basically, one-seventh, or, as described in the statute, $14\frac{2}{7}$ percent of the amount of a lump sum distribution is added to the recipient's income in the year of receipt and the additional tax resulting from such additional income is multiplied by seven to arrive at the total additional tax. Surprisingly, examples can be constructed in which the additional tax that is computed through use of the formula will, in the aggregate, be lower than the tax which would have resulted from application of capital gain rates. The availability of this lesser tax arises from two factors. First, the rate on capital gains realized by individuals, in excess of \$50,000 annually, can be over thirty percent,

62. See H.R. REP. NO. 91-413, pt. 1, *supra* note 34, at 153-56; H.R. REP. NO. 91-413, pt. 2, 91st Cong., 1st Sess. 111-13 (1969).

63. See S. REP. NO. 91-552, 91st Cong., 1st Sess. 200-03 (1969).

64. Amend. No. 319, 115 CONG. REC. S16052-56 (daily ed. Dec. 8, 1969). The original "bunched income" concept was prominent among the reasons advanced by Senator Inouye in support of his amendment.

65. See H.R. REP. NO. 91-782, *supra* note 58, at 318.

66. The provision is effective for taxable years ending after December 31, 1969, and applies generally only to distributions paid, and for benefits accrued, after December 31, 1969. See Tax Reform Act of 1969, tit. V, § 515(c), 83 STAT. 646 (codified at INT. REV. CODE OF 1954, §§ 402(a)(2), 403(a)(2)).

67. See principally INT. REV. CODE OF 1954, § 72(n)(4).

68. See INT. REV. CODE OF 1954, § 72(n)(2) for the H.R. 10 formula. In lieu of the specific averaging formulas of § 72(m)(2), (4), the general income averaging provisions of the Code may be elected. See INT. REV. CODE OF 1954, § 1304(b)(2) (amended by the Tax Reform Act of 1969, tit. V, § 515(c)(4), 83 Stat. 646).

compared to the prior maximum rate of twenty-five percent.⁶⁹ Second, other compensation income received during the year by the recipient of the lump sum distribution is not taken into account in determining the ordinary income rate at which one-seventh of the distribution will be subject to tax, thereby reducing the applicable ordinary income rate.⁷⁰ Consequently, in some situations the elimination of capital gain treatment in favor of an ordinary income rate formulation will have the anomalous result of producing a lesser tax for the recipient-employee.

In view of the conflict demonstrated in the legislative history of the 1969 Act, coupled with similar H.R. 10 struggles in prior years, it should not be unexpected that, with regard to the tax treatment of lump sum distributions from qualified plans, we have a jumble and an inconsistency of rules and consequences that rivals and, perhaps, surpasses the subchapter S tangle already discussed. The variations in tax treatment are manifold. Putting aside differences in variations developed through the application of effective date rules and the opportunity to elect the general income averaging provision of the Code,⁷¹ and without attempting to develop every possible variation, we can isolate five basic kinds of tax treatment applicable to lump sum distributions. The 1969 Act can take its share of responsibility for creating or at least breathing life into a number of these categories. There does not appear to be a sound basis for these distinctions.

The kinds of tax treatment are:

1. Taxable as capital gain—a distribution⁷² with respect to a qualified

69. Tax Reform Act of 1969, tit. V, § 511, 83 Stat. 635 (codified at INT. REV. CODE of 1954, § 1201).

70. INT. REV. CODE of 1954, § 272(m)(4)(B). For this purpose, compensation does not include "deferred compensation within the meaning of section 404." Query, whether income realized by an employee pursuant to the new restricted property rules, Tax Reform Act of 1969, tit. V, § 321 constitutes deferred compensation for this purpose? Compare a similar reference in the fifty percent maximum tax on the earned income provision. *Id.* § 804 (codified at INT. REV. CODE of 1954, § 1348), which reference seemingly attempts to set forth, for purposes of that provision, the particulars of the relationship between deferred compensation within the meaning of § 404 and income that is realized pursuant to the new restricted property rules. The clarification of the issue will doubtless have to await the issuance of regulations.

71. See Tax Reform Act of 1969, tit. V, § 511, 83 Stat. 635 (codified at INT. REV. CODE of 1954, § 1201).

72. In each case other than category 3, distribution refers to a qualifying "separation from service" or "death" lump sum distribution and the amount taxable is computed after deducting the employee's basis which will consist of (1) contribution amounts that he, not the employer, has made on his own behalf, plus (2) amounts previously

plan participant who is not a self-employed individual for H.R. 10 purposes, other than the portion of the distribution which is referable to the employer's contributions on behalf of the recipient-employee.⁷³

2. Taxable as ordinary income subject to special seven-year averaging—a distribution with respect to a qualified plan participant who is not a self-employed individual for H.R. 10 purposes, other than the portion of the distribution which is subject to tax as capital gain under category 1, if the person to whom the distribution is made has been a participant in the plan for five or more years.⁷⁴

3. Taxable as ordinary income subject to a special five-year averaging—a distribution⁷⁵ with respect to a qualified plan participant who is a self-employed individual for H. R. 10 purposes, other than the portion of the distribution which is subject to the special penalty computations of category 5, if the person to whom the distribution is made has been a participant in the plan for five or more years.⁷⁶

4. Taxable as ordinary income without amelioration by averaging devices—a distribution with respect to a qualified plan participant, whether or not he is a self-employed individual for H.R. 10 purposes, other than those portions of the distribution which are taxable as capital gain under category 1, or are subject to the special penalty computation of category 5, if the person to whom the distribution is made has been a participant in the plan for less than five years.⁷⁷

5. Taxable as ordinary income subject to special penalty computations—a distribution to a person who is an owner-employee for H.R. 10 purposes, if the distribution is excessive or is made earlier than permitted by statute.⁷⁸

Of the above conglomerate of consequences, the consequence described by category 2 is entirely new; the consequence described by category 1 is a replacement for prior broader capital gain treatment; and the consequence described by category 4 is an expansion of that class for the purpose of absorbing a portion of the category 1 treatment which is not absorbed by category 2.

included in the employee's income. See INT. REV. CODE of 1954, §§ 402(a)(2), 74(f). In the case of category 3, distribution refers only to qualifying lump sum distributions if made after the self-employed individual reaches age 59½, dies, or becomes disabled. See *id.* § 72(n)(1)(B)(i)-(iv).

73. *Id.* §§ 402(a)(5), 403(a)(2)(C).

74. *Id.* § 72(n)(1), (3), (4).

75. See note 72 *supra*, particularly the last sentence thereof.

76. INT. REV. CODE of 1954, § 72(n)(1), (2), (3).

77. See *id.* § 72(n)(1)(C).

78. *Id.* § 72(m)(5), (n)(1)(D).

In the fifty-year-old words of George Holmes, "The complexities of the present system involve too much administrative labor—simplification is necessary" ⁷⁹ Complexity has run rampant and has foreclosed any attempt to treat like cases in a like manner.

PROFESSIONAL SERVICE CORPORATIONS

As previously noted, H.R. 10 was originally enacted for "small business . . . and independent professional practice." ⁸⁰ Section 531 of the 1969 Act was presumably designed to reestablish the application of H.R. 10 to small businesses. Although in some cases the section does reach professional practice, it is not really responsive to the situation that has been developing with respect to professional practice over the past ten years. During this period the states have been enacting professional service corporation statutes which enabled professionals, such as physicians, dentists, engineers, architects, etc., to undertake their practices in corporate form rather than the traditional individual or, at least, noncorporate form. ⁸¹ Even without the utilization of subchapter S elections these professionals, through their corporations, could develop substantial qualified retirement plan benefits far exceeding those available under H.R. 10.

The first response to this progression of events was the issuance by the Revenue Service of regulations that exclude professional service corporations from the definition of corporations for federal income tax purposes. ⁸² The courts, however, with one very recent and perhaps not totally germane exception, ⁸³ were unanimously upholding taxpayers and permitting the incorporation approach. ⁸⁴ On August 8, 1969, the Revenue Service conceded the battle and agreed that organizations under state professional association acts would generally be treated as corporations. ⁸⁵ Up to this point, the issue had generally been thought of as an

79. See G. HOLMES, *supra* note 20.

80. H.R. REP. NO. 378, *supra* note 29.

81. See note 30 *supra*.

82. See Treas. Reg. § 301.7701-2(h) (1965).

83. Jerome J. Roubik, . . . T.C. . . . (1969).

84. See, e.g., *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969); *United States v. Empey*, 406 F.2d 157 (10th Cir. 1969); *Smith v. United States*, 301 F. Supp. 1016 (S.D. Fla. 1969); *Williams v. United States*, 300 F. Supp. 928 (D. Minn. 1969); *Cochran v. United States*, 299 F. Supp. 1113 (D. Ariz. 1969); *Wallace v. United States*, 294 F. Supp. 1225 (E.D. Ark. 1968); *Holder v. United States*, 289 F. Supp. 160 (N.D. Ga. 1968); Rev. Rul. 70-101, 1970 INT. REV. BULL. No. 9 at 13.

85. Tech. Inf. Rel. 1019 (Aug. 8, 1969). A more recent and more comprehensive

administrative or judicial one. It was anticipated that a resolution would develop primarily through the litigation process. In fact, the Revenue Service's concession in August occurred after the House of Representatives passed the 1969 Act.⁸⁶ At no point had the subject of professional service corporations been on the Congressional agenda with respect to the 1969 Act.

On October 26, 1969, *The New York Times* published a front page article, the first sentence of which stated that "[t]housands of physicians across the country have begun to take advantage of a lucrative tax device that is saving many of them more than \$15,000 a year in taxes."⁸⁷ The remainder of the article carried forward the tenor of the first sentence. The Senate Finance Committee immediately responded. Despite the fact that the professional service corporation issue had not been considered previously by Congress and not one word of public testimony had been heard with respect to the issue, the bill, as reported by the Committee, contained a provision which would have, in general, imposed H.R. 10 standards for qualified retirement plans of professional service corporations.⁸⁸

The Senate, after extensive debate, adopted Senator Fannin's amendment deleting the Senate Finance Committee's provision.⁸⁹ The status of the law, as it had been developed in the courts, was thus reestablished. The rejection of the Finance Committee's approach seemed to have been based primarily on the representation of the Treasury Department that the entire matter of qualified plans, including those applicable to professional service corporations, would be considered in the near future.⁹⁰

Although the argument for equality of treatment among qualified retirement plans for self-employed individuals, subchapter S corporations, and professional service corporations has appeal it is only appropriate that those persons who oppose this position should have the opportunity to present their opposition in public. Given the failure to provide such a forum, the rejection by Congress of the proposed professional service

statement of the concession is contained in Rev. Rul. 70-101, 1970 INT. REV. BULL. No. 9, at 13.

86. The House of Representatives passed the bill on August 7, 1969.

87. Blakeslee, *Physicians Profit from Tax Device*, N.Y. Times, Oct. 26, 1969, at 1, col. 5.

88. It appeared as § 901 of the Senate version of H.R. 13270 and would have been reflected as new § 72(p) of the INT. REV. CODE of 1954.

89. Amend. 296, 115 CONG. REC. S16,241-50 (daily ed. Dec. 9, 1969).

90. See the letter of Deputy Assistant Secretary of the Treasury, John S. Nolan, which was quoted by Senator Tower during the Senate debate, 115 CONG. REC. S16,242 (daily ed. Dec. 9, 1969).

corporation reform was not unwarranted. Furthermore, if the Senate Finance Committee version had been enacted, professional service corporations would have been governed by neither H.R. 10 rules nor the new subchapter S rules, but would have fallen within a set of standards entirely their own. For example, whereas under H. R. 10 plans forfeitures are not permitted for any employee, and under subchapter S plans forfeitures are not permitted for stockholders-employees, under the proposed professional service corporation reform forfeitures would have been permitted, but the amount referable to stockholder-employees would have had to have been included in the incomes of such employees. As a result, the amount of the forfeitures would have been permitted to accumulate tax-free within the fund. This is only one illustration of the kinds of permutations that would have been developed if the new section had been passed.⁹¹

The action of the Congress in rejecting the amendment appears appropriate in light of the procedural setting in which it arose. It appears just as appropriate however, that the issue should be considered at length. Presumably, the Treasury Department will take the lead in presenting the matter to the Congress for consideration.

RESTRICTED PROPERTY

Although prolixity is one of the means by which tax statutes become unduly complicated, it is not inevitably an evil to be avoided. In many cases precision and clear meaning can only be accomplished through the use of lengthy and detailed language. The kind of complexity that more seriously plagues tax statutes concerns the multiplication of arbitrary distinctions among *de jure* situations having similar *de facto* qualities.

In the new restricted property rules there is a provision that requires thousands of words and four pages of the text of the public law.⁹² Despite its surface complexity, however, the section tends to eliminate capricious distinctions. It applies a single set of tax consequences to restricted property, whether or not the taxpayer receives the property under a stock option arrangement, a deferred compensation plan, or some third kind of arrangement involving the per-

91. *E.g.*, under the subchapter S provision there is no coordination of rules if a person is a stockholder-employee in more than one corporation; there would have been such coordination in the case of professional service corporations. In another illustration, the five percent stock ownership test of the subchapter S provision would not have been utilized for professional service corporations. In the latter situation, any equity owner would have been deemed to be a stockholder-employee.

92. Tax Reform Act of 1969, tit. V, § 321, 83 Stat. 588.

formance of services and the payment of compensation therefor. It thereby eliminates unnecessary variations in tax consequences that have been in the law for over twenty-five years.⁹³

The rules respecting the compensatory receipt of restricted property prior to the passage of the 1969 Act existed in the regulations (and not directly in the Internal Revenue Code) as a function of the law of non-statutory stock options.⁹⁴ The establishment of those rules was, in part, a response to the Tax Court's *Lehman* decision.⁹⁵ They also reflected the learnings of other cases including certain Supreme Court decisions.⁹⁶ In general, under the Regulations, an individual who received property subject to restrictions having a substantial effect on the property's value, whether he received that property as a function of a stock option arrangement⁹⁷ or as a direct payment by the employer,⁹⁸ was deemed to have realized taxable ordinary income at the time the restrictions lapsed. The amount included in income was the lower of the value of the property at the time he received it (computed as if the restrictions did not then encumber the property) or the value at the time the restrictions lapsed.⁹⁹

Such a rule tends to maximize the capital gain, as contrasted to the ordinary income, element of restricted property. As a consequence, shortly before the end of the Johnson Administration, the Treasury Department issued proposed regulations which would have caused the recipient to include in income the value of the property at the date the restrictions lapsed (without any reference to a possible lower value when the property was first received). The regulations were never promulgated in final form.¹⁰⁰

The Ways and Means Committee's placement of the restricted property subject on its agenda can be understood only in the light of this briefly sketched background. At no point did there appear to be any obvious

93. See Statement of Assistant Secretary of the Treasury *Edwin S. Cohen*, *supra* note 1, at 60.

94. Treas. Reg. § 1.421-6 (1966).

95. Robert Lehman, 17 T.C. 652 (1951), *acquiesced in*, 1952-1 CUM. BULL. 3, *not acquiesced in*, Tech. Inf. Rel. 248 (Aug. 29, 1960).

96. Commissioner v. LoBue, 351 U.S. 243 (1956); Commissioner v. Smith, 324 U.S. 177 (1945). See TAX MANAGEMENT PORTFOLIO No. 87-2nd, *Stock Options* (Nonstatutory) (1965), for a chronology of the more recent changes in the regulations.

97. Treas. Reg. § 1.421-6(d) (1966).

98. Treas. Reg. § 1.61-2(d)(5) (1966).

99. This value is reduced, of course, by the amount paid by the employee for the property.

100. Prop. Treas. Reg. § 1.421-6(d) (Oct. 26, 1968).

recognition of the fact that these rules respecting restricted property were different, perhaps capriciously different, from the rules respecting deferred compensation, even where the practical distinctions between the two types of situations were difficult to perceive. Initially, no one asked whether the establishment of a nonqualified deferred compensation trust that is funded with contractually nontransferable, but otherwise traded, stock should be treated differently from the direct receipt by the employee of the same contractually nontransferable, but otherwise traded, stock. Is the employee under one arrangement blessed with a measurably greater benefit than the employee under the other arrangement? By the passage of section 321 of the 1969 Act, enacting section 83 of the Internal Revenue Code, Congress responded in the negative and applied the same rule to both situations.¹⁰¹ Like facts are to be treated in a like way without any recognizable loophole opening and with a decided reduction in statutory complexity. In net result, a new set of rules has become pertinent for nonqualified funded deferred compensation.

The general rule, with a series of technical adjustments the analysis of which would not serve a specific purpose here,¹⁰² is as follows: The transfer of restricted property to an employee in connection with the performance of services will cause the market value of that property (determined without regard to the restrictions) to be included in the employee's income at the time the property becomes transferable or is not subject to a substantial risk or forfeiture.¹⁰³ Basically, the approach attempts to marry the transferability criteria of the prior restricted property rules to the forfeiture criteria previously applicable, in a less strict form, to funded deferred compensation.¹⁰⁴

101. Tax Reform Act of 1969, tit. V, § 321(b), enacts changes in INT. REV. CODE of 1954, § 402(b), § 403(c)(d), with the effect of applying the restricted property rules of INT. REV. CODE of 1954, § 83 to nonqualified trusts and annuities.

102. The statute considers special problems of restrictions which will never lapse, holding periods, relationship to tax free exchanges and transitional rules. See INT. REV. CODE of 1954, § 83(d), (f), (g), (i). In addition, an election is provided to employees in certain circumstances to be taxed under a special "non-deferral" rule. See INT. REV. CODE of 1954, § 83(b).

103. Such substantial risk exists if the right to the property is conditional on the performance of substantial future services. INT. REV. CODE of 1954, § 83(c)(1). This approach represents a decided tightening of previously applied forfeiture standards which normally required a lesser commitment by the employee, e.g., simple availability for consultation.

104. Of noteworthy significance is the statute's solution to the problems of matching the timing of deduction and income and, more seriously, of losing the deduction entirely in certain nonqualified plan situations. See *id.* § 404(a)(5) before amendment

Although the rule has schematic plausability and tends to improve the technical quality of the statute, it is subject to one very serious and perhaps fatal question: Is it constitutional?

Envision a young executive who, like most members of this consumption-oriented society, has little or no accumulated capital. He has reached a corporate level which entitles him to receive substantial restricted stock, stock which may not be transferred to third persons for a number of years. Assume that the stock has a market value, without restrictions, of \$50,000. Because the employee has vested rights in the property (within the meaning of the statute),¹⁰⁵ he must include the full \$50,000 in taxable income. If his marginal tax rate is a modest forty percent, after adding this \$50,000 of income to his base salary, he will be faced with an additional \$20,000 tax liability. His lack of other capital eliminates one possible source of cash with which to pay the tax. In addition, because the stock is nontransferable it will not be possible for the employee to pledge it as security for a loan, the proceeds of which could be used to pay the tax. Thus, we are presented with the disturbing sight of a taxpayer who has taxable income but no income or other resources with which to discharge the statutorily imposed tax obligation. In addition, under the 1969 Act his failure to pay the tax with the filing of his tax return could conceivably result in the imposition of a penalty equal to twenty-five percent of the tax underpayment, *i.e.*, another \$5000.¹⁰⁶

Clearly the above hypothetical brings into question the wisdom of the restricted property rule that was finally adopted. More to the point for our purposes, it challenges the constitutionality of the approach. Although tax statutes are rarely held to be unconstitutional and, in addition, there is little reliable learning on the outer constitutional dimensions of the term "net income," the new restricted property rule appears to stretch those dimensions to the breaking point.

If the *Stratton's Independence, Ltd. v. Howbert*¹⁰⁷ definition of income as "gain derived from capital, from labor, or from both com-

by the Tax Reform Act of 1969, tit. V, § 321(b)(3), 83 Stat. 591; *Mississippi River Fuel Corp. v. Kohler*, 266 F.2d 190 (8th Cir. 1959), *cert. denied*, 361 U.S. 827 (1959); *Russell Manufacturing Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959). With the enactment of the Tax Reform Act of 1969, tit. V, § 321(b)(3), 83 Stat. 591 the deduction will be taken by the employer at the same time the employee realizes income. See INT. REV. CODE of 1954, §§ 83(h), 404(a)(5).

105. It is not subject to a substantial risk of forfeiture.

106. Tax Reform Act of 1969, tit. V, § 943; INT. REV. CODE of 1954, § 6651.

107. 231 U.S. 399, 415 (1913).

bined . . ." is used as a starting point, we are dealing with an item which, if it is income, seems to be gain derived from labor. But is there gain? Although the courts recently have been rather liberal in accelerating the recognition of taxable income, they have invariably dealt with situations in which the taxpayer is in possession of property that is cash or does not suffer from legal restrictions on its convertibility into cash.¹⁰⁸

Our normal accrual tax accounting concepts would cause an item to be "includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."¹⁰⁹ Section 83 transcends the accrual concept since any reasonably accurate valuation approach at the time of receipt of the property would have to take into account a discount factor for the restrictions. At this time it is not possible to judge accurately the value the property will have when the restrictions lapse. By the time the restrictions lapse the property may be worthless. The employee may never, in any meaningful way, receive the income which the statute credits him with having realized.¹¹⁰

Section 83 establishes a fictional income which may or may not reflect the income actually received when the restrictions lapse. Assuredly, the determination of an appropriate rule here is a very difficult task and the rule reflected in section 83 has a number of virtues, some of which have been considered herein. The difficulty of the undertaking, however, cannot be accepted as an excuse for the creation of a consequence that is probably unconstitutional.

NONFUNDED CONTRACTUAL PROMISE

We have previously stated that the rules respecting funded, non-qualified deferred compensation and those concerning restricted property should ideally be the same; and, in fact, section 321 of the 1969 Act attempts to accomplish just such an equalizing feat. That section, however, fails to account for nonfunded deferred compensation. So

108. *See, e.g.*, Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Association v. United States, 367 U.S. 687 (1961); Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969).

109. Treas. Reg. § 1.451-1(a) (1969).

110. Further, if we look to the time rule with respect to the sale or exchange of property, we find that the amount realized in such an event consists of cash plus the fair market value of property received in exchange. INT. REV. CODE OF 1954, § 1001. The fair market value of property that is subject to restrictions is clearly not the same as the value of that property without restrictions.

long as this latter kind of deferred compensation is governed by a separate set of rules which cannot be reconciled with the section 321 approach, the statute will have a basic deficiency. The distinction between funding and nonfunding is simply too weak a fulcrum on which to pivot the difference in tax treatment. As described above, the receipt of an interest in a separate trust that is funded with nontransferable stock should be treated no differently than the direct receipt of such nontransferable stock. Similarly, a nonassignable promise from General Motors or any corporate or noncorporate person, as the employer, to make a payment in the future, even possibly measured by the market movement of General Motors stock, should be generally governed by the same tax rules as those applicable to funded arrangements.

The 1969 Act made no change in the existing rules respecting nonfunded deferred compensation. As a consequence, now, as for a number of years past, the tax treatment of nonfunded deferred compensation is governed primarily by Revenue Ruling 60-31.¹¹¹ In essence, the timing and the amount of the recognition of taxable income in a nonfunded deferred compensation arrangement is dependent on the application of the esoteric constructive receipt and economic benefit concepts.¹¹² Attempts have been made to analyze Revenue Ruling 60-31 in terms of those theories.¹¹³ The analyses are not always illustrations of precision and clarity, however, not because the attempts are inept or inadequate, but because the subject matter, particularly the economic benefit theory, defies clarity.

Revenue Ruling 60-31 could, with allowances for imprecision, be described as stating in general that an item paid in return for the performance of services is included in the employee's income when he receives or constructively receives it or when it is received by a third person, such as a trustee, for the nonforfeitable economic benefit of the employee.

Although the 1969 Act, as passed, did not contain a specific provi-

111. 1960-1 CUM. BULL. 174.

112. The constructive receipt theory addresses itself to the timing of income rather than to the question of what constitutes income. "Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, or set apart for him, so that he may draw upon it at any time. . . ." Treas. Reg. § 1.451-2(a) (1964). The economic benefit theory attempts to isolate the types of noncash property and rights which may be received as income. See, e.g., *id.* § 1.61-2(d)(1) (1966); § 1.446-1(a)(3) (1961).

113. See, e.g., TAX MANAGEMENT PORTFOLIO No. 20-3rd, *Deferred Compensation Arrangements* (1969).

sion that was directed to the question of nonfunded deferred compensation, the matter was considered by the Congress during the development of the Act. The House Ways and Means Committee proposed a rule which was adopted by the House,¹¹⁴ but deleted by the Senate.¹¹⁵ Under this proposal, nonfunded deferred compensation would have been included in income at the time of its receipt, but at the tax rates (determined through a special computation) which were applicable at the time it was earned.

The Ways and Means Committee supported its suggested change by noting¹¹⁶ that: (1) the current difference in tax treatment between funded and unfunded arrangements does not have a sound basis; (2) the availability on a discriminatory basis, to only selected employees, of the deferred compensation tax rate reduction benefit is inequitable; and (3) the new fifty percent earned income tax rate limitation reduces the need for special deferred compensation tax rules.¹¹⁷

The choice of approach selected by the Committee is difficult to understand in view of the reasons set forth for its adoption. There was no attempt to equate the tax treatment of funded and nonfunded

114. It appeared as § 331 of the House version of H.R. 13270 and would have been reflected as new § 1354 of the INT. REV. CODE of 1954.

115. See S. REP. No. 91-552, *supra* note 63, at 306.

116. It is anomalous that the tax treatment of deferred compensation should depend on whether the amount to be deferred is placed in a trust or whether it is merely accumulated as a reserve on the books of the employer corporation. An employee who receives additional compensation in the form of a promise to pay him that compensation in the future made by a large, financially sound corporation, is probably as likely to receive the compensation as an employee whose deferred compensation is placed in trust. Your committee believes that the possibility of shifting income to taxable years after retirement when the marginal tax bracket is expected to be lower should not be available to employees who are in a position to bargain for deferred compensation arrangements and to rely on the unsecured obligation of their employers, when such benefits are not available to other employees. Your committee believes that the 50 percent limitation on the marginal tax rates applicable to earned income contained in its bill is a further reason for the adoption of this provision.

H.R. REP. No. 91-413, *supra* note 34, at 70.

117. Tax Reform Act of 1969, tit. VIII, § 804, 83 Stat. 685 (codified at INT. REV. CODE of 1954, § 1348) provides, in general, that compensation income will not be taxed at a rate higher than fifty percent. Thus, whereas formerly deferral of compensation income to a lower bracket retirement year could result in a maximum rate reduction equal to the difference between seventy percent and the retirement year's tax bracket, that reduction will now be no greater than the difference between fifty percent and the retirement year's tax bracket. In effect, there has been an elimination of a maximum possible benefit equal to twenty tax rate points previously accruable through the use of deferred compensation.

deferred compensation, nor was a discrimination standard proposed. Although we can only conjecture, the existence of this gap between cause and effect may have played a part in leading the Senate to delete the proposal. Of course, the Senate could have made the deletion with full knowledge that the Treasury favored such action and had promised to undertake a comprehensive study of the problem.¹¹⁸

The approach of the Ways and Means Committee appears to make little sense in view of the new rules for funded deferred compensation. The same lack of rational base, however, can be assigned to continuation of the Revenue Ruling 60-31 approach. It is not the Senate's action in deleting the provision which should be called into question; it is rather the failure of Congress to provide uniform rules respecting all deferred compensation. We assume, of course, that very shortly the Treasury will assist Congress in correcting the omission.

CONCLUSION

The 1969 Act's handling of deferred compensation suffers from a common ill of tax legislation. The statute's catalytic motivations are described in terms of broad and symmetrical reforms intended to bring into harmony the various parts of the whole. Such motivations, however, typically miss their mark and merely spawn interstitial solutions to exceedingly narrow problems. The celestial reach of the reformer stands aside for the limited grasp of the legislative draftsman who has much the more difficult task. The "patchwork" or "crazy-

118. The Treasury Department recommended that this provision be deleted from the bill. The Treasury indicated that further analysis was necessary to determine whether the proposed solution was consistent with the cash basis of accounting and whether alternative solutions were available. The Treasury also indicated there are a number of problems in the practical operation of the provision which it believed had not been solved satisfactorily. Among these are the scope of the term "deferred compensation," and the determination of the year in which deferred compensation is deemed to have been earned. The Treasury Department has undertaken a comprehensive study of both qualified and nonqualified employee benefit plans, and it intends, as part of this study, to develop recommendations dealing with the tax consequences of all deferred compensation arrangements.

The committee agrees with the concern of the House in this regard, but believes that the administrative difficulties associated with the House provision make further study desirable. The committee has, therefore, deleted this provision from the bill pending further study by the Treasury Department. S. REP. No. 91-552, *supra* note 63 at 307.

quilt" patterns of the 1969 Act's deferred compensation provisions are, therefore, not surprising or unique.

Fortunately, in contrast to much of our past tax enactment, there may be a greater reason to believe that a more permanent and workable solution will eventually emerge from the taxing efforts of 1969. The Treasury has committed itself to develop and put before Congress a comprehensive and logically interrelated income tax system for deferred compensation. Hopefully, the long and passionately sought answers will be found.