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# Averaging Provisions of the Code: Compensation From an Employment (Internal Revenue Code of 1954, §1301)

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# AVERAGE PROVISIONS OF THE CODE — COMPENSATION FROM AN EMPLOYMENT
(Internal Revenue Code of 1954, § 1301)*

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*Origin of section 1301*

Section 1301 of the 1954 Internal Revenue Code (and its predecessor section 107 of the 1939 Code), was designed to relieve the inequity which results when a taxpayer receives in one taxable year compensation which may be attributable in whole or in part to services performed in prior years. Ordinarily a taxpayer would be required to pay taxes on such compensation in the one taxable year which, unless otherwise alleviated, would impose a greater burden than would be the case were the taxes assessed ratably over the period during which the services were performed. Accordingly, the so-called "averaging provisions" of section 1301 can result in a substantial tax saving and cause the tax burden to be borne more equitably.

Provisions for special treatment of long term income first appeared in section 107 of the Code of 1939[1]. Section 107 was amended substantially by the Revenue Act of 1942 in that it was made applicable to compensation for personal services received by an individual or partnership which covered a period of thirty-six months (formerly, five years), the percentage of total compensation required to be received in one

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1 Int. Rev. Code of 1939, § 107, "Compensation for services rendered for a period of five years or more. In the case of compensation (a) received, for personal services rendered by an individual in his individual capacity, or as a member of a partnership, and covering a period of five calendar years or more from the beginning to the completion of such services, (b) paid (or not less than 95 percentum of which is paid) only on completion of such services, and (c) required to be included in gross income of such individual for any taxable year beginning after December 31, 1938, the tax attributable to such compensation shall not be greater than the aggregate of the taxes attributable to such compensation had it been received in equal portions in each of the years included in such period."

year being eighty percent (formerly, ninety-five percent), and the compensation was not required to be received only on completion of the services[2].

It has been said that section 107 of the 1939 Code and therefore section 1301 of the 1954 Code, require the application of two opposing general rules of construction insofar as income tax statutes are concerned. First, these sections constitute an exception to the general rules governing taxation of income and, therefore, are exemption statutes which must be strictly construed and become applicable only where the taxpayer clearly shows himself to be entitled to the benefits of the statute[3]. On the other hand, the statute is a remedial one which must be liberally construed in favor of the taxpayer[4]. This brings into play a third rule of construction, namely, that the common sense interpretation should be followed[5]. It is rather disturbing to think that a common sense interpretation would not always be applicable.

Briefly, section 1301 of the 1954 Internal Revenue Code provides for a limitation on the tax of an individual or partnership (the rule with respect to partners to be discussed hereinafter) if: (1) the individual or partnership engages in an "employment"; and (2) such "employment" covers thirty-six months or more from beginning to completion thereof; and (3) the gross compensation from such "employment" received or accrued in the taxable year is not less than eighty percent of the total compensation from such employment. If the fore-

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[2] Int. Rev. Code of 1939, § 107, "(a) Personal services. If at least eighty percentum of the total compensation for personal services covering a period of thirty-six calendar months or more (from the beginning to the completion of such services) is received or accrued in one taxable year by an individual or a partnership, the tax attributable to any part thereof which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual."

[3] E.g., Lindstrom v. Commissioner, 149 F2d 344 (9th Cir. 1945).

[4] Slough v. Commissioner, 147 F2d 836 (6th Cir. 1945).

[5] See discussion in Annot., 29 A.L.R.2d 592, 601, 602 (1953).

going tests be complied with, then the tax attributable to any part of such compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of receipt of accrual[6].

*Definition of "Employment"*

Under section 1301, "employment" is defined as an arrangement or series of arrangements for performance of personal services to effect a particular result regardless of the

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[6] Int. Rev. Code of 1954, § 1301. Compensation from an Employment.

(a) Limitation on Tax.—If an individual or partnership—

(1) engages in an employment as defined in subsection (b); and

(2) the employment covers a period of thirty-six months or more (from the beginning to the completion of such employment); and

(3) the gross compensation from the employment received or accrued in the taxable year of the individual or partnership is not less than eighty percent of the total compensation for such employment, then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.

(b) Definition of an Employment.—For purposes of this section, the term "an employment" means an arrangement or series of arrangements for the performance of personal services by an individual or partnership to effect a particular result, regardless of the number of sources from which compensation therefor is obtained.

(c) Rule with Respect to Partners.—An individual who is a member of a partnership receiving or accruing compensation from an employment of the type described in subsection (a) shall be entitled to the benefits of that subsection only if the individual has been a member of the partnership continuously for a period of thirty-six months or the period of the employment immediately preceding the receipt or accrual. In such case the tax attributable to the part of the compensation which is includable in the gross income of the individual shall not be greater than the aggregate of the taxes which would have been attributable to that part had it been included in the gross income of the individual ratably over the period in which it was earned or the period during which the individual continuously was a member of the partnership, which-

number of sources of such compensation[7]. Section 107 of the 1939 Code applied to compensation "for personal services". The 1954 Code was revised to make it clear that tax benefits are allowed only where the compensation relates to a particular project and not to a series of unrelated services[8]. Frequently, under the 1939 Code long term income benefits depended on either the combination of different services which in the aggregate extended over the required period or the division of such services so as to meet the eighty percent requirement. Such manipulation gave rise to much of the litigation under the 1939 Code and, therefore, the present terminology "compensation from an employment" was adopted in an attempt to eliminate a result obviously not intended.

Regulation § 1.1301-2(b) further defines an "employment" by setting up certain guides. It is provided that whether an employment exists is a question which must be determined by a consideration of all the facts in each case and the primary factor in making such determination is what the particular profession, business or industry would normally consider as a distinct project or result. The examples given would indicate that the definition of "employment" in and of itself offers fertile ground for discussion and litigation even if the manipulation which existed under the 1939 Code, above discussed, has been effectively eliminated. The time when an employment begins and ends and whether the period over which an employment extends includes conference and study time, also depend upon the facts of each case. Further, the services must relate to a particular project and must consist of a set of unrelated services performed for the same person[9].

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ever is the shorter. For purposes of this subsection, a member of a partnership shall be deemed to have been a member of the partnership for any period, ending immediately prior to becoming such a member, in which he was an employee of such partnership, if during the taxable year he received or accrued compensation attributable to employment by the partnership during such period."

[7] Int. Rev. Code of 1954, § 1301(b).

[8] Reg. § 1.1301-2(b).

[9] Compare the following examples given by Reg. § 1301-2(b):
"Example 1. A was retained by X Corporation to perform general legal services. During the period 1955 through 1960, A performed miscellaneous

*Thirty-Six Months and Eighty Percent*

Once the question of "employment" has been determined the application of the other two criteria come into play, namely, that the employment must cover a period of at least thirty-six months and that compensation of not less than eighty percent shall have been received in the taxable year. This best can be illustrated by an example[10]: A, an individual who makes his income tax returns on a calendar year basis and uses the cash receipts and disbursements method of accounting, began an employment, as above defined, on February 17, 1951, and completed it on July 1, 1954. A's total compensation from such employment was $9,000.00 of which he received $1,000.00 on July 1, 1953, and $8,000.00 on the completion date. Since the employment covered more than thirty-six months and the $8,000.00 received in 1954 was not less than eighty percent of A's total compensation for such employment, he is entitled to the benefits of section 1301 in computing the tax payable with respect to the $8,000.00 reflected in his 1954 return. Section 1301 does not apply to the $1,000.00 received in 1953. Under section 1301(a) the tax attributable to the $8,000.00 included in A's gross income for 1954 shall not be greater than the aggregate of the taxes attributable to such amount had it been received ratably over the calendar months included in the period from February 17,

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legal services on numerous unrelated matters, each of which effected a particular result, and some of which extended over a period of more than thirty-six months. A was compensated by a single payment in 1960. A's services do not constitute an employment either as to the unrelated matters on which he worked or the general services performed over the period 1955 through 1960, since the arrangement was for the performance of services generally and not for the performance of any particular results.

Example (2). B was retained as an attorney by the Y Corporation to perform general legal services. An anti-trust action was brought against Y and since the defense of such an action was beyond the scope of the agreement to perform general legal services, a separate arrangement was entered into between Y and B, whereby B was to be paid a specified additional amount for defending Y in the anti-trust suit. B's services in connection with such suit represented an employment separate and distinct from his general legal services for Y, and such services are performed pursuant to a separate arrangement."

10 Suggested by Reg. § 1301-2(a), Example (1), and Reg. § 1301-2(c), Example (1).

1951 to July 1, 1954. The allocation of the compensation to the period of employment would be as follows:

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|---|---|
| 1951 (10 months) | $2,000.00 |
| 1952 (12 months) | 2,400.00 |
| 1953 (12 months) | 2,400.00 |
| 1954 ( 6 months) | 1,200.00 |

Thus it will be seen that the $8,000.00 payment on July 1, 1954, should be taxed as if it had been received ratably over the years indicated. The month of February, 1951, was not counted in determining the total number of months inasmuch as there was less than one-half calendar month involved[11].

Under Regulation § 1.1301-2(c) the allocation of income is explained as follows:

> The compensation from an employment is to be treated as if it had been received in equal portions in each of the calendar months (including those of the current taxable year) which fall within the period of employment preceding the receipt or accrual of the compensation. Thus, the portion of the compensation allocable to each taxable year involved in such period of employment is an amount equal to the entire compensation from the employment received or accrued in the current taxable year, divided by the entire number of calendar months included within the part of the period of employment which precedes the date of receipt or accrual of such compensation, and multiplied by the number of such calendar months falling within the particular taxable year.

Therefore, assume that in the foregoing example A had commenced employment on March 3, 1954, and had completed it on August 22, 1957, and had been paid a total compensation of $28,000.00 for that employment on July 5, 1956. The tax attributable to the $28,000.00 included in A's gross income for 1956 cannot be greater than the aggregate of the taxes attributable to such amount had it been received ratably

[11] Int. Rev. Code of 1954, § 1307.

over the calendar years included in the period from March 3, 1954, to July 5, 1956, the date on which the $28,000.00 was received. Thus, the $28,000.00 would be taxed as if it had been received as follows:

| | |
|---|---|
| 1954 (10 months) | $10,000.00 |
| 1955 (12months) | 12,000.00 |
| 1956 (6 months) | 6,000.00 |

It should be noted that the total number of months involved in this example insofar as ratable distribution is concerned is only twenty-eight months but this is not the determinative factor. The period of employment was more than thirty-six months[12].

*Computation and Allowances*

Regulation § 1.1301-2, further sets forth the steps involved in the computation of the tax, these steps being enumerated as:

(1) Compute the tax for the current taxable year by including in the gross income of such year the compensation from an employment received or accrued in such year.

(2) Compute the tax for the current taxable year without such inclusion.

(3) Compute the tax attributable to the compensation from an employment allocated to each of the taxable years in accordance with the income allocation above discussed. The amount of tax attributable to the compensation from the employment so allocated is the difference between the tax for each such year computed with the inclusion in gross income of each year of the allocable portion of such compensation and the tax for each year computed without such inclusion.

(4) The tax for the current taxable year shall be the lesser of (a) the tax for the current taxable year computed under paragraph (1) above or (b) the tax for such year as

[12] Suggested by Reg. § 1301-2(a), Example (2), and Reg. § 1301-2(c), Example (3).

computed under paragraph (2) above, plus the aggregate of the taxes attributable to the allocated compensation as computed under paragraph (3) above[13].

Further in computing the tax for any taxable year any item which depends upon the amount of gross income, adjusted income or taxable income shall be recomputed to take into consideration the amount of compensation allocated to each year. For example, this affects the general limitation on charitable deductions, medical expenses, net operating loss carryback or carryover or capital loss carryover[14].

Where there are overlapping periods, that is to say, where an individual takes advantage of section 1301 in computing his tax for a particular year, and in a subsequent year again qualifies for such treatment with respect to other compensation, the period of which coincides to any extent with the period of the previous employment, he must, in the computation for the subsequent year, take into consideration the fact that he has previously allocated income for those years which overlap[15].

*Rule with Respect to Partner*

Section 1301 provides a special rule as to services rendered by a partner. A partner is entitled to tax benefits under this

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13 Reg. § 1301-2(d)(1).

14 Reg. § 1301-2(d)(2).

15 Reg. § 1.1301-2(d)(4) gives this example: An individual commenced an employment on January 1, 1950, and completed it on December 31, 1954, at which time he received $60,000.00 as total compensation therefrom. In connection with his 1954 return he allocated $1,000.00 to each of sixty calendar months included within the period of employment in determining his income tax under the provisions of section 1301. He also commenced a second employment on January 1, 1952, and completed it on December 31, 1955, at which time he received total compensation of $48,000.00. In determining whether the limitation on tax prescribed in section 1301 is applicable for the calendar year of 1955 he must, in connection with allocating $1,000.00 to each of the forty-eight calendar months included within the period of such employment and computing the tax attributable thereto, also include in his income for the years 1952, 1953 and 1954 the amount of $12,000.00 previously allocated to each of such years in connection with his return for the calendar year 1954.

section with regard to long term compensation received or accrued by the partnership after March 1, 1954, only if he has been a member of the partnership continuously for thirty-six months or the period of the employment immediately preceding the receipt or accrual of the compensation[16].

Regulation § 1.1301-2(e)(1) sets forth the qualifications for limitation on tax. It is immaterial whether the individual actually rendered services with respect to the employment to which compensation is attributable.

Regulation § 1.1301-2(e)(2) also specifies the limitation on the tax, this limitation being that a qualifying partner, with respect to a share of partnership income includable in his gross income, shall bear a tax attributable to such share which shall not be greater than the aggregate of the taxes which would have been attributable to such share had it been included in the gross income of the partner ratably over (a) the period in which it was earned immediately preceding the receipt or accrual of the compensation by the partnership or (b) the period during which the individual continuously was a member of the partnership immediately preceding such receipt or accrual, whichever is the shorter period[17].

In the case of allocation of income where received by a partner who was formerly an employee it is provided that such former employee shall be deemed to have been a member

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16 Int. Rev. Code of 1954, § 1301(c).

17 Reg., § 1.1301-2(e)(2) sets forth the following:
"Example (1). A became a member of the ABC partnership on June 1, 1950. The partnership, which is on the calendar year basis, began an employment on June 1, 1952, and completed it on July 1, 1955. On June 1, 1954, the partnership had received $24,000.00 as total compensation from such employment. A's $8,000.00 share of such compensation was included in his gross income for 1954. Since the $24,000.00 payment was from an employment of the type described in section 1301(a) and since A had been a member of the partnership continuously for more than thirty-six months at the date of the receipt of the payment, A is entitled to allocate his $8,000.00 share over the period in which the income was earned prior to the date of its receipt by the partnership. Thus, for purposes of making the tentative tax computation, A must allocate the $8,000.00 ratably over the period from June 1, 1952 through May 31, 1954."

of the partnership for the period during which he was an employee ending immediately prior to his becoming a member of the partnership[18]. Again, it is immaterial for the purposes of section 1301 and the regulation construing the same that such an individual, as an employee, actually rendered services with respect to the employment to which such compensation is attributable[19].

Where an individual engaged in employment becomes a member of a partnership which continues with such employment, the employment shall be considered, with respect to such individual, as one employment covering both the period during which a portion of the employment was performed by such individual in his capacity as such and the period during which a portion of the employment was performed by the partnership[20].

Lastly, the withdrawal of a partner from a partnership or the termination of a partnership will not bring an employment to an end with respect to any partner who continues to participate in such employment either in his individual capacity or as a partner in a partnership which continues with such employment[21].

*Cases and Rulings*

As would be expected, there have been numerous cases and rulings dealing with the averaging provisions as to long term income under section 107 of the 1939 Code and many of these will be applicable to section 1301 of the 1954 Code[22]. Several of the more pertinent authorities should be considered.

In *Estate of W. P. McJunkin*[23] it was held that expenses are not deductible to reduce the total compensation of which

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18 Int. Rev. Code of 1954, § 1301(c).

19 Reg. § 1.1301-2(e)(4).

20 Reg. § 1301-2(e)(3).

21 Reg. § 1301-2(c)(5).

22 See cases cited in 4 C.C.H. 1959 Stand. Fed. Tax Rep., §§ 4780, 4783 and P-H 1959 Fed. Tax Serv., § 7960-7975.

23 26 T.C. 16 (1955).

eighty percent must be received in a taxable year. There, during the years of 1935 through 1944 the decedent received $29,250.00 for services rendered as trustee and of this sum he received $22,500.00 in the year 1944. He claimed the benefit of section 107(a) of the 1939 Code on the ground that, if the gross compensation received were reduced by certain expenses claimed to be applicable to the services as trustee, the net compensation received in 1944 would be more than eighty percent of his total net compensation for all the years. This contention was disallowed.

On the other hand, in *Charles Spicer*[24] it was held that expenses in connection with gaining compensation are not required to be spread back and allocated to previous years when the benefits under the long term income provisions of the Internal Revenue Code are sought. Therefore, a legal fee paid by the petitioners in the year 1947 was held to be deductible in its entirety in that year.

An interesting case involving the question of the unity of the services performed by the taxpayer who sought relief under section 107(a) of the 1939 Code is *Robert M. Drysdale*[25]. Drysdale, an attorney, represented certain inspectors for the Immigration Department in the prosecution of suits and claims for Sunday and holiday pay. He sought to lump the various suits and claims together in order to meet the thirty-six months' requirement for long-term compensation relief. The Tax Court held that each claim had to be treated separately because the claim of each inspector was a distinct individual right. The claims could not be grouped so as to qualify.

Insofar as section 1301 itself is concerned there have been several definitive rulings.

In Revenue Ruling 58-101[26], the Internal Revenue Service was requested to advise whether the fair market value of a

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[24] 13 C.C.H. Tax Ct. Memo 452 (1954).

[25] 14 C.C.H. Tax Ct. Memo 227 (1955), *affirmed*, 232 F.2d 633 (6th Cir. 1956).

[26] I.R.B. 1958-11, 28.

house received by a taxpayer as a prize for taking part in a contest should be included in gross income for the year in which title to the property was transferred or the benefits and burden of ownership received or whether the prize should be considered as having been earned over a longer period. Among other things, it was held that the efforts expended by the taxpayer which resulted in his winning the prize did not constitute an "employment" the compensation from which would be subject to the benefits afforded by section 1301[27].

Revenue Ruling 57-436[28] presented the question as to whether the personal services of a co-trustee of an *inter vivos trust* constitute an "employment" within the meaning of section 1301 and whether, upon termination of the trust and judicial approval of the proceedings, he would be entitled to compute and pay federal income tax on the compensation received for his services as provided under section 1301. The taxpayer was a co-trustee of a revocable trust established by an indenture which provided for the payment of the net income therefrom to the grantor for life and upon her death the termination of the trust and the distribution of its assets. The taxpayer served continuously as a trustee until the trust was terminated at the death of the grantor, a period of twenty years. The state court entered a decree settling the trustee's account covering the entire term of the trust in order for payment of commissions with respect to the receipt and distribution of both the trust corpus and trust income and otherwise to the taxpayer. Such amount was paid to him in a single lump sum immediately following entry of the decree. It was held that the trustee who performed such services during his life was engaged in an "employment" within the meaning of section 1301 and entitled to the benefits of such section.

Lastly, Revenue Ruling 58-326[29] presented the question as to whether or not an informer's reward leading to the de-

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27 In Rev. Rul. 55-642, 1955-2 Cum. Bull. 302 it was held that where a taxpayer won an award in a contest conducted to promote the sales of a company's product, he was not entitled to the benefits of Int. Rev. Code of 1954, § 1301.

28 1957-2 Cum. Bull. 588.

29 I.R.B. 1958-26, 17.

tection and punishment of persons guilty of violating the Internal Revenue laws was entitled to the benefits of section 1301. It was held that the offer of the Commissioner to pay a reward for information by the taxpayer informer did not, as between the Commissioner and the informer, result in such a contractual arrangement as to constitute an "employment" as such term is comprehended under section 1301[30].

An interesting question not answered by any reported decision as of this date is whether or not deferment of compensation in order to obtain section 1301 benefits is proper. However, it would appear that the timing of receipt of income would not be contrary to the spirit or the purpose of the law. In many instances the taxpayer has some measure of control over the time of receipt of compensation as, for example, executors' commissions, which compensation covers services rendered over a long period and the time of receipt of such compensation can result in substantial tax saving.

Almost four years have elapsed since section 1301 became effective, an increased volume of cases and rulings dealing with this section undoubtedly will be forthcoming in the very near future as the taxpayers seek to obtain the benefits of this section. The sphere of judicial and administrative interpretation probably will extend primarily to the new definition of an "employment" and, to a lesser extent, to the specific provision dealing with partners. Until section 1301 has been more thoroughly explored the regulations offer ample guides to the practitioner—but, as a relief provision, it undoubtedly will be explored!

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30 See Barker v. Shaughnessy, 278 App. Div. 742,103 NYS2d 326 (D.C.) 55-1 U.S.T.C., § 9116 (1954), and Elmer J. Faul, 29 T.C. 450 (1957).