

February 1958

Taxation--Deferred Compensation Plan for Controlling Stockholder

J. S. T.

West Virginia University College of Law

Follow this and additional works at: <https://researchrepository.wvu.edu/wvlr>



Part of the [Business Organizations Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

J. S. T., *Taxation--Deferred Compensation Plan for Controlling Stockholder*, 60 W. Va. L. Rev. (1958).
Available at: <https://researchrepository.wvu.edu/wvlr/vol60/iss2/11>

This Case Comment is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact ian.harmon@mail.wvu.edu.

UNIFORM RULES OF EVIDENCE § 26, which maintains that the privilege should be protected if the communication is overheard in a manner not reasonably to be anticipated by the client.

The argument presented thus far would seem to place the attorney-client communication beyond the reach of the law; however, this is not the case. Aside from the client's waiver of the privilege it may be destroyed on other grounds. For an excellent theoretical discussion see Mr. Justice Cardozo's opinion in *Clark v. United States*, 289 U.S. 1, 13 (1933). The privilege may be destroyed where there is a substantial showing that legal aid was sought for the perpetration of future crime or fraud. See *In re Selser*, 15 N.J. Super. 393, 105 A.2d 395 (1954); cf. *State v. Childers*, 196 La. 554, 199 So. 640 (1940). Thus, in the principal case the legislative committee was not without a means of exposing the communication, had they been able to establish a right to abrogate the privilege under this principle.

It is submitted that the court in the principal case permitted the legislative committee to impinge on the civil liberties of an individual by disposing of an essential privilege through the application of finely drawn distinctions which have no justification in reason or principle. Although the attorney-client privilege has no express guarantee in the Constitution, and is basically an expression of policy, it is indispensable to the administration of justice and should not be dealt with in a capricious manner.

J. O. F.

TAXATION—DEFERRED COMPENSATION PLAN FOR CONTROLLING STOCKHOLDER.—A corporation, engaged in the manufacture of clothing, entered into a deferred compensation agreement with its president and majority stockholder (98 of 100 shares), the taxpayer. To fund the agreement the corporation purchased a combined life and annuity contract insuring his life, whereby taxpayer was to receive a monthly payment for life as a pension, and the corporation was declared owner and beneficiary of the policy. The Tax Court, in affirming the Commissioner's determination, held the annual premiums paid by the corporation to be a taxable dividend to taxpayer, the transaction lacking bona fides and being merely an attempt to use corporate funds without taxation. *Held*, that

the taxpayer had no legal interest in the policy and received no immediate personal benefit from the corporate purchase of the policy; therefore, not taxable. Reversed. *Casale v. Commissioner*, 247 F.2d 440 (2d Cir. 1957).

Deferred compensation plans have often been involved in tax litigation, see, e.g., *Wolfe v. Commissioner*, 170 F.2d 73 (9th Cir. 1948); *Richard R. Deupree*, 1 T.C. 113 (1942); but in the principal case we have the added factor of the controlling stockholder involved.

Simply speaking, a deferred compensation is any delayed payment for services. A clearer understanding of a typical deferred compensation plan may be gained from the following example: "As additional compensation for services to be rendered in 1957, employer promises to pay employee or his estate \$10,000 in \$1,000 annual installments commencing on the first day of the year following his sixty-fifth birthday." Lefevre, *Deferred Compensation Plans*, N.Y.U. 15th INST. ON FED. TAX. 1081 (1957). To finance such a plan, an insurance policy is usually purchased by the corporation, and whether payments on this policy create a present benefit to the employee is the issue in the present case.

From the decision of the principal case, three factors appear which should be considered in determining the taxability of the stockholder in deferred compensation plans of this sort.

First, that a corporation is an entity separate and distinct from its stockholders is a well-settled principle of law. *Kanawha-Roane Lands v. United States*, 136 F. Supp. 631 (S.D.W. Va. 1955); *Commonwealth Title Co. v. Rothensies*, 124 F. Supp. 274 (E.D. Pa. 1954); *Jeffries v. Commissioner*, 158 F.2d 225 (5th Cir. 1927).

The lower court, in adding up (1) the similarity between the compensation agreement and the policy issued, (2) the fact that the taxpayer owned 98% of the corporate stock, and (3) the right of the taxpayer to change beneficiaries, arrived at the conclusion that the transaction was a sham, and that the corporation was no more than a conduit running from the insurer to the taxpayer. While it is agreed that the taxpayer *controls* the corporation, the court in the instant case rightly refused to allow a further conclusion that the taxpayer *is* the corporation. The Supreme Court has recognized an exception to this principle; the corporate form may

be disregarded when it is a sham or unreal. *Moline Properties v. Commissioner*, 319 U.S. 436 (1943); *Gregory v. Helvering*, 293 U.S. 465 (1935). But in the instant case, the corporation has been formed for a definite purpose and a legitimate business.

A second factor to be considered is the element of control over the insurance contract, and in connection with this, the third factor of the benefit of the policy must also be discussed.

Although the corporation was named owner of the policy, the Commissioner points out that the taxpayer retained the right to change the beneficiary under the agreement, thus asserting control of the plan. However, all incidents of ownership end here. The policy was a corporate asset; the corporation paid premiums, had the right to assign and the right to receive dividends, and could borrow on the policy.

To emphasize the fact that the corporation had control of the policy, it is important to realize the possibility that creditors of the corporation could reach the cash value of the policy, just as they can reach all corporate assets. *Cf. Lincoln Nat'l Life Ins. Co. v. Scales*, 62 F.2d 582 (5th Cir. 1933). Therefore, insolvency of the corporation could destroy the seemingly definite benefit to the taxpayer.

It is important to remember that under a deferred compensation plan of this sort, the insurance *may* be used to pay the compensation benefits, but such benefits may be paid from some other asset, and in the same sense, the policy might be used for some other corporate use.

In light of the foregoing, the following conclusions seem plausible from the court's decision:

(1) The corporate entity will be recognized, notwithstanding the fact that the corporation is controlled by one or more majority stockholders, unless a sham is definitely proved.

(2) The control and benefits of a policy in a deferred compensation plan must be retained solely by the corporation. A slight incident of ownership by the taxpayer or control by a third party, destroying the possibility of corporate creditors reaching the policy, may defeat the corporate control argument.

(3) Any element of control of the policy in the hands of the taxpayer or noncontrol by the corporation may give rise to an immediate taxable benefit to the taxpayer.

The decision in the principal case has received a boost by a subsequent First Circuit holding under a somewhat similar factual situation. *Prunier v. Commissioner*, 5 CCH 1957 Stand. Fed. Tax Rep. (57-2 U.S.T.C.) ¶ 10,015 (1st Cir. Nov. 8, 1957). The court regarded as a settled ruling "that where a corporation is the beneficiary and owner of a policy of insurance on the life of an employee or stockholder, the payment of premiums by the corporation does not constitute income to the insured individual," and cites the principal case as authority. *Prunier v. Commissioner*, *supra* at 58,548. However, *Sanders v. Fox*, 149 F. Supp. 942 (D.C. Utah 1957), remains *contra* to the principal case.

The recent decisions in the *Casale* and *Prunier* cases seem to indicate a trend of the circuits; where the corporation owns, controls, and benefits from the policy involved, there is no immediate taxable benefit to the stockholder concerned.

J. S. T.

LEGISLATION

CORPORATIONS—EFFECT OF PROPOSED STOCK VOTING AMENDMENT ON OUTSTANDING STOCK.—West Virginia voters in the 1958 general election will be asked to approve an amendment to the state constitution requiring the legislature to provide by law that every corporation shall have the power to issue one or more classes of stock with full, limited or no voting rights, and that holders of voting shares may vote them cumulatively for directors. W. Va. Acts 1957, c. 18, § 1. This amendment would replace the present provision that the legislature shall provide by law that every stockholder shall have the right to vote the number of shares owned by him cumulatively for directors. W. VA. CONST. art. XI, § 4.

In executing this constitutional requirement, the legislature provided that stockholders could cumulate shares entitled to vote. W. VA. CODE c. 31, art. 1, § 66 (Michie 1955). It also empowered corporations to issue stock with full, limited or no voting power. W. VA. CODE c. 31, art. 1, § 22 (Michie 1955). The possible unconstitutionality of these statutes had long been recognized. Note,