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Payments to Widows of Deceased Employees as Taxable Income of the Widow--I.T. 4027

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involved in these situations can constitutionally confer jurisdiction upon state courts over non-resident *natural persons*, it seems that the same result should be reached in respect to *foreign corporation*. The suggested rule would allow state courts to take jurisdiction over all causes of action connected with solicitation within the state. It would not include a purely transitory cause of action which is unrelated to any act done within the state. Perhaps in this class of cases there is greater merit in the "fair play and substantial justice" theory than any other. If a corporation is carrying on regular and continuous solicitation within the state there is nothing "unfair" in requiring it to defend a suit on a transitory cause of action, but not otherwise.

It is impossible at the present time to determine whether the *Green* case and its "mere solicitation" rule has been completely absorbed in the broader theory of the *International Shoe Co.* case. However, the reception of the latter case by the state and lower federal courts and the broad language of the case itself indicate that in the near future, if not already, "mere solicitation" by a corporation will be sufficient to subject it to the jurisdiction of the state where the solicitation occurred. Therefore, if the decision in the *Green* case has not veen overruled, it may safely be said that it has been quietly interred.

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PAYMENTS TO WIDOWS OF DECEASED EMPLOYEES AS TAXABLE INCOME OF THE WIDOW – I.T. 4027

I.T. 4027,[1] recently issued by the Income Tax Unit of the Bureau of Internal Revenue, has laid down the rule that "irrespective of a plan voluntary or involuntary, definite or indefinite, payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for Federal income tax purposes." This ruling, which is applicable to payments received beginning January 1, 1951, represents a substantial change from the previous Treasury position.

In 1921, in O.D. 1017, the Treasury held that a payment to the widow of a deceased officer of his salary for two months after his death was a gratuity and was not taxable income of the widow. In I.T. 3329,[3] in 1939, it was ruled that payments made for a reasonable time by a corporation to the widow of a deceased officer were deductible by the corporation as a business expense but were not taxable income to the widow. In this I.T., it was said that "When an allowance is paid by an organization *to which the recipient had rendered no service* [italics, writer s], the amount is deemed to be a gift or gratuity and is not subject to Federal income tax in the hands of the recipient." Thus, an attractive opportunity was offered to employers to make tax free "3329 payments" to widows and still deduct them as a business expense.[4] It is clear, however, that the courts have not generally gone as far as the implications of I.T. 3329.

[1] 1950 Int. Rev. Bull. No. 21 at 2; 505 CCH par. 6208.

[2] 5 Cum. Bull. 101 [501 CCH par. 52.474]. This was expressly reversed by I. T. 4027. See also T. D. 2090 to the same effect. Dec. 14, 1914 [501 CCH par. 52.474]. This was expressly overruled by I. T. 4027.

[3] 1939-2 Cum. Bull. 153. This was expressly overruled by I. T. 4027 on the point herein discussed.

[4] P-H Students Tax Law Service, Current Matter, par. 10, 182' (1950).

In 1942, the district court, in the case of *Mary Sutro* v. *U. S.*,[5] held that a lump sum paid to the widow of a deceased employee under a "voluntarv" insurance plan of the employer was taxable as income of the widow. The court said that although the plan was voluntary, there was an enforceable obligation in favor of the widow, and an enforceable obligation and a gift are mutually exclusive. In 1947, in I.T. 3840,[6] the Treasury, relying largely on the *Sutro* case, adopted a rule to the effect that payments received by the widow of a deceased employee pursuant to the terms of a *voluntary* death benefit plan constitute taxable income of the widow. It was said therein that there was an enforceable obligation in such a situation, the consideration for which was the services rendered by the husband.

Flarsheim v. *U S.*, decided in 1946, also involved an enforceable contract. The husband had contracted that after his death, his wife was to receive a payment of $12,000 per year out of the net earnings of a particular one of the employer s offices. The payments had previously been held to be deductible by the employer.[8] While this case is generally treated as a case of payments by an employer to the widow of a deceased employee, it would seem to be distinguishable from the general line of such cases, especially upon the basis upon which the court put its decision. The court treated this as a situation where the widow had received a right to the income from a particular property—a contract right giving her an equitable charge upon the business of the particular office. The court relied upon *Irwin* v. *Gavit*[9] and *Blair* v. *Com r.*[10] in this respect, so it would appear that they were looking at it as a case where the widow received an interest in an income producing corpus or its equivalent.

In 1946, in *Varnedoe* v. *Allen*,[11] payments to a widow of a fireman made pursuant to a state law were held to be income to the widow. It was in this case that the court made the statement, strongly emphasized in I.T. 4027, that "It is not necessary that the services should have been rendered by the payee. The payor is the one to whom the services must have been rendered."[12] A dissent in this case said that the widow should not be taxed. The dissenting judge believed that since part of the money for the payments came from a three per-cent payroll deduction from the husband's salary, that money was his income and should have been taxed to him, and the remainder of the money for the payments was a gift or gratuity from the state. I.T. 3972,[13] in 1949, expressly relied on this case and ruled that a death benefit payment made to the widow of an employee of the Government of the Territory of Hawaii paid pursuant to Hawaiian law was taxable as income. However, here, the husband had made no contribution to the fund from which the payment was made. On the other hand, in a special ruling, in

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[5] 42-2 USTC par. 9523 (N. D. Cal. 1942).
[6] 1947-1 Cum. Bull. 7.
[7] 156 F 2d 105 (C. C. A. 8th 1946).
[8] Seavey & Flarsheim Brokerage Co. v. Com r., 41 B. T. A. 198 (1940).
[9] 268 U. S. 161 (1925) (holding that income given from the income of a trust fund is income to the recipient although the recipient has no interest in the corpus).
[10] 300 U. S. 5 (1937) (holding that the income beneficiary of a trust had an equitable interest in the corpus of the trust so that an assignment by him of the trust income was an assignment of income producing property not an assignment of income due to the assignor).
[11] 158 F 2d 467 (C. A. A. 5th 1946), *cert. denied*, 330 U. S. 821 (1947).
[12] *Id.* at 468.
[13] 1949-2 Cum. Bull. 15.

1946, the Bureau stated that widows of former governors, the present governor, and the governor-elect at the time the statute was passed would not be taxed on a $3,000 annual pension to be paid to them under an Indiana statute, on the ground that such payments constituted gifts.[14]

In *Aprill* v. *Com r.*,[15] a Tax Court case decided in 1949, it was held, with express citation of I.T. 3329, that where the widow had rendered no services and the corporation had no obligation of any kind to pay her, payments to the widow were not taxable as her income. This case was similar to the case laid down in I.T. 3329 in that, in each, the payments were not made pursuant to any enforceable obligation or plan and were authorized only after the death of the husband. The cases do differ in that in the *Aprill* case, the commissioner was attempting to tax payments which the employer had not been allowed to deduct. However, payments had been made for two prior years and had been deducted as an expense without any attempt by the commissioner to tax the widow or disallow the deduction.

In *Haden* v. *Com r.*,[16] in 1946, the employer claimed a deduction for payments made to a widow. The Tax Court disallowed the deduction, and, in its opinion, stated, "In the absence of a finding that the payments made to the widow are in the nature of additional compensation, and in the absence of a contract with the deceased employee for such payments, *they must be considered as gifts, which are not taxable to the recipient* [italics, writer s] "[17]

Thus stood the law on this matter before I.T. 4027.

Section 126 of the Internal Revenue Code provides that income in respect of a decedent is taxable as income when received by a person who, by reason of the death of the decedent, acquires the right to receive such amount. None of the cases or rulings just discussed consider the applicability of this section except I.T. 3840,[18] which didn't appear to rely on it but merely cited it at the end. While it may be that this section is applicable in such cases, its applicability is open to question.[19]

Nowhere has the writer found the possibility discussed that these cases, at least the ones involving enforceable contracts, might be cases of third-party beneficiary contracts with the widows as donee beneficiaries. Perhaps this absence of discussion alone is sufficient to cause such a possibility to be discounted. In the *Flarsheim* case, the court stated that the wife was a third party beneficiary,[20] but it apparently placed no significance on that fact. However, Paul says that a third party beneficiary may be the recipient of a gift taxable under the gift tax.[21] Even in the case of annuity payments received by a third party beneficiary, the recipient is taxed, under the income tax law, only on that part of the payments

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[14] Feb. 14, 1946, 464 C. C. H. par. 6241.

[15] 13 T. C. 707 (1949).

[16] 5 T. C. M. 250 [reported at 464 C. C. H. par. 7403] (1946), *aff'd* & *rev d on other issues*, 165 F 2d 588 (C. C. A. 5th, 1948).

[17] 5 T. C. M. 250, — as quoted in 505 C. C. H. par. 8713C and in Oberndorfer, *Payments to Widows of Deceased Employees*, 25 Taxes 711 at 719 (1947).

[18] *Supra* note 6. See Oberndorfer, *op. cit. supra* note 17 at 717.

[19] See 501 C. C. H. par. 52.472; 505 C. C. H. par. 8713C. For a discussion of the reason for the enactment of Sec. 126, see GRISWOLD, CASES on FEDERAL TAXATION 374 (3rd ed. 1950).

[20] 156 F 2d 105, 107 (C. C. A. 8th 1946). Also see statements in Mary Sutro v. U. S., 42-2 USTC par. 9523 (N. D. Cal. 1942).

[21] 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION sec. 16.13 (1942).

which represent interest on the sum originally paid by the donor but is not taxed on that part of the payments which represent the cost to the donor.[22]

Nor has the *Lucas* v. *Earl*[23] concept, that income is taxed to the person who earned it, been alluded to in any of the foregoing cases or rulings except the *Flarsheim* case, wherein the widow made such a contention. There the court rejected it, relying principally upon the particular facts of that case in that, the husband had no interest in the office which produced the income and had no interest in the future income earned by it which he could assign. The court, therein, said that *Lucas* v. *Earl* and similar cases "turn on the principle that title to income when produced belongs to the owner of the fund which produced it."[24] However, at least one writer has criticized these cases taxing payments to widows on the ground that they apparently violate the *Lucas* v. *Earl* principle.[25]

But regardless of these possible criticisms, it seems clear that payments to the widow of a deceased employee have ultimately been treated the same as payments to living employees.[26]

Regulation 111, Sec. 29.22(a)-2 which says in part, "However, so-called pensions or gratuities awarded *by one to whom no services have been rendered* [italics, writer's] are mere gifts or gratuities and are not taxable," has been considered as inapplicable to such cases as discussed herein because services have been rendered to the employer.[27] It is uncertain whether I.T. 3329 was intended to be based upon this Regulation or whether it was intended to be based on a belief that such payments as it considered actually constituted gifts.

It is not completely clear just how far I.T. 4027 is intended to go. It purports to apply only to payments made "in consideration of services rendered by the officer or employee." This clearly does not mean that "consideration" in the contract sense is necessary There need be no legal obligation before the payments will be treated as made for consideration and not a gift.[28] A moral obligation may be sufficient. Past services may be treated as consideration for payments by an employer which are intended as additional compensation.[29] Thus, the problem arises as to whether payments to widows which are not deductible by the employer fall within the scope of the I.T. or are gifts. Payments made to the widow of a deceased employee are often deductible by the employer because they are paid as compensation for past services and are reasonable in amount, or are paid pursuant to a plan or contract liability.[30] Also, Regulation 111, Sec. 29.23(a)-9 allows a deduction *for a limited period* for payments of the decedent's salary to his widow in recognition of past services rendered.[31] When the deduction for such payments is disallowed from the outset, or when it is disallowed because the limited period has passed, it might be that the courts will consider the payments to be *gifts*, which are excluded from gross income in Section 22(b) of the Internal

[22] Sec. 22 (b) (2) of the Internal Revenue Code. MAGILL, TAXABLE INCOME 434 (2nd ed. 1945).

[23] 281 U. S. 111 (1930).

[24] 156 F 2d 105, 108 (C. C. A. 8th 1946).

[25] Oberndorfer, *op. cit. supra* note 17 at 716, esp. n. 45.

[26] *Ibid.*

[27] Oberndorfer, *op. cit. supra* note 17 at 718; I. T. 4027, cited *supra* note 1.

[28] MAGILL, *op. cit. supra* note 22 at 401.

[29] *Id.* at 395.

[30] Oberndorfer, *op. cit. supra* note 17· 505 C. C. H. par. 8586; *see* Pfeifer Corp. v. Com'r., 14 T. C. — No. 71 (as reported in 505 C. C. H. par. 7384) (1950); McLaughlin Gormley King Co. v. Com'r., 11 T. C. 569, 575 (1948).

[31] See 505 C. C. H. par. 8713D; I. T., 3329, *supra* note 3.

Revenue Code.[32] The *Aprill* case held such non-deductible payments to be gifts, and the *Haden* case called them gifts.[33] However, it is not absolutely necessary that payments made to former employees be deducted before they can be considered as compensation.[34] It is apparently the opinion of some that the new I.T. is intended to tax even the non-deductible payments.[35] It has also been suggested that as a result of this new ruling, the right of employers to deduct may possibly be extended by the Treasury since there is no longer any reason why the employer should not be able to deduct them.[36] However, it is not too unlikely that the purpose of the new ruling is to eliminate the tax loophole of "3329 payments," and thus, may be intended to tax *all* such deductible payments but only to tax those payments which are deductible by the employer.

Irrespective of these possibilities, it is clear that if I.T. 4027 meets the approval of the courts, another type of income has been removed from that very exclusive category of tax-free income.

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[32] "Such rejection of the gift concept in all cases faces a battle in the courts. In the long run, it may be decided that three months pay to a professor s widow is a true gift and nontaxable, although two years' high salary to the widow of an industrialist carries too much aroma of prearrangement to be treated otherwise than as *post mortem* earned compensation." Maguire, *Individual Federal Income Tax in 1951*, 36 A.A.U.P. 766 at 771 (1950).

[33] Also *see* Blair v. Rosseter, 33 F 2d 286, 287 (C. C. A. 9th 1929); *cf.* Benyon v. Thorpe, [1928] 97 L. J. K. B. 705, 44 T. L. R. 610. But *see*, Bass v. Hawley, 62 F 2d 721, 723 (C. C. A. 5th 1933). All are cases dealing with gifts to employees.

[34] MAGILL, *op. cit. supra* note 22 at 399.

[35] See 505 C. C. H. par. 8493; P-H Students Tax Law Service, Current Matter, par. 10,182 (1950); 505 C. C. H. 8521 apparently says that treatment of payments to widow as her income and treatment of payments as not deductible by the employer are two separate and distinct matters, citing Putnam v. Com r., 15 T. C. — No. 13, reported at 505 C. C. H. par. 7585.

[36] P-H Students Tax Law Service, *supra* note 35.