T.C. Memo. 1947-170

When an employer uses funds to purchase an annuity for an employee as compensation for services, the amount paid for the annuity is taxable income to the employee in the year of purchase.

Summary

Robert F. Chapin had an agreement to receive $12,000 per year from the Brady estate for past, present, and future services. In 1939, this agreement was modified, and Chapin received $8,660.80 in cash, with the remaining funds used to purchase annuity contracts selected by Chapin. The Tax Court held that the entire $80,000 (cash plus cost of annuities) was taxable income to Chapin in 1939 because it represented compensation for services rendered. The court emphasized that Chapin had the option to receive the full amount in cash but chose to have part of it used for annuity purchases.

Facts

- Chapin worked for the Brady estate for many years.
- In 1929, Nicholas Brady agreed to pay Chapin $12,000 per year as compensation for his "services past, present and future."
- Prior to 1939, Chapin did not report any of these payments as taxable income.
- In 1939, Chapin settled his arrangement with the Brady estate, receiving $8,660.80 in cash.
- The remaining funds from the settlement were used to purchase annuity contracts selected by Chapin.

Procedural History

The Commissioner of Internal Revenue determined that the $80,000 received by Chapin in 1939 (cash plus cost of annuities) was taxable income. Chapin petitioned the Tax Court for a redetermination, arguing that the annuity purchase was merely a substitution of one annuity for another and should not be considered income.

Issue(s)

1. Whether the cash received by Chapin in 1939 from the settlement constitutes taxable income under Section 22(a) of the Internal Revenue Code.
2. Whether the amount used to purchase annuity contracts for Chapin in 1939 constitutes taxable income in that year.

Holding

1. Yes, because the cash payment represented compensation for services rendered.
2. Yes, because the amount used to purchase the annuity contracts was also

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compensation for services rendered and Chapin had the option to receive the entire amount in cash.

Court's Reasoning

The court reasoned that the cash received by Chapin was clearly taxable income as it represented monthly payments for services rendered. Regarding the annuity contracts, the court emphasized that Chapin was offered the balance in cash but chose to have it used to purchase annuities. The court cited *Richard R. Deupree, 1 T. C. 113*, and *George Matthew Adams, 18 B. T. A. 381*, to support its holding that the entire amount used to purchase the annuity contracts is taxable income. The court distinguished the annuity contracts from the original agreement, noting that the contracts represented an absolute right to receive annuities, whereas the Brady letter was merely a promise to pay compensation. The court stated, "the cost of annuities purchased to compensate the petitioner for services is income in 1939 under the circumstances here present." The court also noted that payments under the annuity contracts could be reported under section 22(b)(2) of the Internal Revenue Code.

Practical Implications

This case establishes that when an employer compensates an employee by purchasing an annuity for them, the value of the annuity is considered taxable income to the employee in the year the annuity is purchased, especially if the employee had the option to receive the funds directly. This ruling affects how compensation packages are structured, requiring employers and employees to consider the immediate tax implications of annuity purchases. Later cases applying this ruling consider whether the employee had a choice to receive cash instead of the annuity. If so, the economic benefit doctrine applies. This case is distinguishable from situations where the annuity is part of a qualified retirement plan, which has different tax rules.

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