Levine v. Commissioner, 44 T. C. 360 (1965)

Payments labeled as sick pay must represent bona fide compensation for employees and not disguised distributions to shareholders to be excluded from gross income.

Summary

In Levine v. Commissioner, the Tax Court held that payments made to Samuel Levine, the majority shareholder and principal executive of Selco Supplies, Inc. , did not qualify as excludable sick pay under section 105(d) of the Internal Revenue Code. Despite a resolution allowing sick pay during illness, the court found these payments to be taxable dividends due to Levine's dominant position and the absence of a genuine employee sick pay plan. This decision emphasizes the need for a bona fide plan and rational basis for payments to employees, not merely as a distribution to shareholders, and highlights the court's scrutiny of the circumstances surrounding such payments.

Facts

Samuel Levine, the majority stockholder and principal executive officer of Selco Supplies, Inc. , underwent a cancer operation in September 1957. On October 1, 1957, a meeting at his home resulted in a resolution allowing Levine and other regular employees to draw sick pay during their illness, limited to $100 per week. The officers who voted on these benefits were Levine's immediate family members. No written documentation of the plan was provided to employees, and while employees were informed about receiving pay during illness, they were not told about the existence of a formal plan or that payments would continue indefinitely. During the tax years 1960-62, Levine received payments which he claimed as excludable sick pay.

Procedural History

Levine's case was brought before the Tax Court to determine whether the payments he received during 1960-62 qualified as sick pay under section 105(d) of the Internal Revenue Code. The Tax Court, after reviewing the evidence and circumstances, ruled that these payments were taxable dividends rather than excludable sick pay.

Issue(s)

1. Whether the payments made to Samuel Levine during the tax years 1960-62 constituted excludable sick pay under section 105(d) of the Internal Revenue Code.

Holding

1. No, because the payments were not made to Levine as an employee but as a principal stockholder, thus they were taxable as dividends.

Court’s Reasoning

The Tax Court scrutinized the nature of the payments made to Levine, emphasizing that the fundamental premise of the regulations under section 105(d) requires a bona fide plan with a rational basis for employee compensation. The court highlighted that the payments were not made because Levine was an employee but due to his dominant position as the principal stockholder. The court noted the absence of a written plan, the limited information provided to employees, and the unrealistic financial burden on Selco to pay indefinite sick pay. The court cited previous cases like John C. Lang and Alan B. Larkin to support its position that the label of sick pay must be examined to determine its true nature. The court concluded that the payments were taxable dividends, not excludable sick pay, as they were not part of a genuine employee sick pay plan but rather a distribution to a shareholder.

Practical Implications

This decision underscores the importance of establishing and documenting a bona fide sick pay plan for employees, especially in small family corporations. It emphasizes that payments labeled as sick pay must genuinely represent compensation for employees and not serve as a means to distribute profits to shareholders. For legal practitioners, this case highlights the need to carefully review the circumstances surrounding payments to ensure compliance with tax regulations. Businesses, particularly those with shareholder-employees, must ensure that any sick pay plan is clearly defined, communicated, and applied consistently to avoid reclassification of payments as taxable dividends. Subsequent cases have referenced Levine v. Commissioner to determine the legitimacy of employee benefit plans, reinforcing the need for transparency and fairness in compensation arrangements.

