Levine v. Commissioner, 44 T. C. 434 (1965)

Payments labeled as sick pay to majority shareholders may be taxable as dividends if not part of a bona fide employee sick pay plan.

Summary

In Levine v. Commissioner, Samuel Levine, the majority shareholder of Selco Supplies, Inc. , received payments during his extended illness, which he claimed as non-taxable sick pay. The Tax Court ruled these payments were taxable dividends, not sick pay, because they were made due to Levine's ownership rather than his status as an employee. The court found that Selco did not have a genuine sick pay plan that would justify such extended payments, emphasizing that for sick pay to be excludable from gross income, it must be part of a bona fide plan applicable to all employees and not just a distribution to shareholders.

Facts

Samuel Levine, the majority shareholder and principal executive of Selco Supplies, Inc. , underwent cancer surgery in September 1957. On October 1, 1957, at a meeting at Levine's home, Selco's officers, all family members, voted to allow Levine to draw sick pay indefinitely during his illness, capped at $100 per week. Similar provisions were made for other employees, but only for short-term illnesses. Levine received these payments during the tax years 1960-62 and sought to exclude them from his gross income as sick pay.

Procedural History

Levine filed a petition with the Tax Court to challenge the IRS's determination that the payments he received were taxable dividends rather than excludable sick pay. The Tax Court reviewed the case and issued its opinion in 1965.

Issue(s)

1. Whether the payments received by Levine during his illness were excludable from gross income as sick pay under section 105(d) of the Internal Revenue Code of 1954.
2. Whether these payments were made to Levine as an employee or because of his status as the majority shareholder of Selco.

Holding

1. No, because the payments did not constitute sick pay under a bona fide plan applicable to all employees.
2. No, because the payments were made to Levine due to his ownership of Selco rather than his employment status.

Court's Reasoning

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The court's decision hinged on the requirement that sick pay must be part of a bona fide plan under section 105(d) of the IRC. The court found that Selco's "plan" lacked the necessary structure and evidence to qualify as such, particularly for long-term payments. The court emphasized that payments to Levine were disproportionate to Selco's financial capacity and the benefits provided to other employees, suggesting they were made due to his ownership rather than his employee status. The court cited previous cases like John C. Lang and Alan B. Larkin to support its view that the label of "sick pay" was insufficient without a genuine plan. The court concluded, "We cannot conclude that the payments in controversy, at least during the tax years 1960-62, represent bona fide sick pay to Levine as an employee. "

Practical Implications

This decision clarifies that payments labeled as sick pay to majority shareholders or owners may be scrutinized and reclassified as taxable dividends if they are not part of a bona fide employee sick pay plan. Legal practitioners should advise clients to ensure any sick pay plans are well-documented, uniformly applied, and financially feasible for the business. This case has implications for small businesses and family corporations, where distinguishing between employee compensation and shareholder distributions can be complex. Subsequent cases have referenced Levine when examining the tax treatment of payments to owners under similar circumstances.

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