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Taxing Long-Term Compensation: Income Averaging for Spread-Back under the 1964 Revenue Act

C. Dale McClain

TAXING LONG-TERM COMPENSATION: INCOME AVERAGING FOR SPREAD-BACK UNDER THE 1964 REVENUE ACT

I.

INTRODUCTION

Under our present graduated income tax system, there has always existed the problem of how to tax the individual whose income fluctuates widely from year to year so that he pays only his fair share of federal income tax.[1] An attempt was made in the past, through specific sections of the Internal Revenue Code, to equalize the tax burden by the use of a "spread-back" provision.[2] The "spread-back" provision limited the taxpayer's liability to what it would have been had the extraordinary or, as it is sometimes called, the "bunched" income been included in the gross income of the taxpayer ratably over the period for which the income was earned.[3] The provision caused a great deal of speculation concerning who was eligible for relief.[4] and whether, for the purpose of computing charitable and medical deductions, the taxpayer's current adjusted gross income was reduced to reflect the spread-back.[5] Subsequent regulations of the Internal Revenue Service and litigation have fairly well defined the problem of who is entitled to relief,[6] but the problem of the effect of the spread-back on the current year's adjusted gross income has not been as easily solved.[7]

1. For general literature concerning the problem of bunched income, the following material is helpful: 1 MERTENS, FEDERAL INCOME TAXATION, §§ 6.09-.15 (1962); Harris, *Spreading Fees Forward and Back*, N.Y.U. 18TH INST. ON FED. TAX 1231 (1960); Taylor, *Tax Relief Income Attributable to Several Years*, 36 TAXES 701 (1958).
2. The first such attempt was in the Int. Rev. Code of 1939, § 107(a), added by ch. 247, § 220(a), 53 Stat. 878 (1939), as amended, ch. 619, § 139(a), 56 Stat. 837 (1943). Section 1301(a) of the 1954 Code extended the availability of relief offered by § 107(a), but did not in any way alter the mode of the provision's operation. INT. REV. CODE OF 1954, § 1301, ch. 736, 68A Stat. 334 (1954). These provisions of the Internal Revenue Code of 1954 (hereinafter cited as "spread-back" provisions) were in force until the passage of the Revenue Act of 1964. The applicable provisions under the later act will hereinafter be referred to as "income averaging" provisions.
3. INT. REV. CODE OF 1954, § 1301, ch. 736, 68A Stat. 334 (1954):
   (a) Limitation on Tax — If an individual or partnership —
   (1) engages in an employment as defined in subsection (b); and
   (2) the employment covers a period of 36 months or more . . . and
   (3) the gross compensation from the employment received or accrued in the taxable year of the individual . . . is not less than 80 per cent of the total compensation from such employment, then the tax attributable to any part of the compensation which is included in the gross income of any individual shall not be greater than the aggregate of the taxes attributable to such part had it been included in the gross income of such individual ratably over that part of the period which precedes the date of such receipt or accrual.
4. See generally, 1 MERTENS, FEDERAL INCOME TAXATION, §§ 6.09-.15 (1962).
5. See the conflict between the *Thayer* and *Wilkinson* rules considered *infra* at text accompanying notes 26 & 31.
6. Treas. Reg. § 1.1301-2 (1954) and Edward C. Thayer, 12 T.C. 795 (1949).
7. Edward C. Thayer, 12 T.C. 795 (1949), and Wilkinson v. United States, 304 F.2d 469 (Ct. Cl. 1962).

No single solution has been found acceptable to the courts, the government and the taxpayers. Therefore, there is presently a low degree of predictability of the ultimate tax result in any given case.[8] Accordingly, a new solution of the problem will be suggested which involves the preparation of theoretical tax returns for each year.[9]

The problem of spread-back income has become almost moot, except for income earned or accrued prior to December 31, 1963, since the Internal Revenue Code provisions which engendered the controversy have been repealed with the passage of the 1964 Revenue Act.[10] Congress apparently realized that a new solution utilizing the old Code provision of spreading back the income was not acceptable, and that a new Code provision was necessary to resolve the conflict between the government, the taxpayer and the courts.[11] The new Code provision was also designed to improve the degree of predictability which was inherent in the prior spread-back provision.[12]

The 1964 Revenue Act provides relief for taxpayers with fluctuations in income through new income averaging rules.[13] The new rules permit the averaging of the additional income in the current taxable year and the payment of a tax based on this average income,[14] rather than recomputing prior years' taxes. The new statute involves extensive calculation, but appears to be a satisfactory solution to the problem equalizing the tax burden.[15] However, problems can be envisioned even under the new statute. It is hoped that by examining the history of legislative and judicial treatment of spread-back income these problems will be made more understandable, thereby providing the first step toward their eventual solution.

II.

THE THAYER AND WILKINSON CONFLICT

Until passage of the Revenue Act of 1964 there existed no income tax provision which was generally available to persons with fluctuating income.[16] There were six specific averaging provisions which dealt with

8. *Ibid.*
9. See text at note 46, *infra.*
10. INT. REV. CODE OF 1954, §§ 1301-05, also called the Revenue Act of 1964, § 232(a); Pub. L. No. 272, 88th Cong., 2d Sess. § 232(a) (Feb. 26, 1964).
11. S. REP. No. 830, 88th Cong., 2d Sess. 140 (1964).
12. 38 N.Y.U.L. REV. 992, 999 (1963).
13. INT. REV. CODE OF 1954, § 1301, Revenue Act of 1964, § 232(a).
14. INT. REV. CODE OF 1954, § 232(a). The new § 1301 of the Internal Revenue Code reads as follows:

> If an eligible individual has averagable income for the computation year, and if the amount of such income exceeds $3,000, then the tax imposed by section 1 for the computation year which is attributable to averagable income shall be 5 times the increase in tax under such section which would result from adding 20 percent of such income to the sum of—
> (1) 133⅓ percent of average base period income, and
> (2) the amount (if any) of the average base period capital gain net income.

15. S. REP. No. 830, 88th Cong., 2d Sess. 140 (1964).
16. S. REP. No. 830, 88th Cong., 2d Sess. 139 (1964).

special types of situations: compensation for personal services,[17] income from inventions or artistic work,[18] backpay,[19] patent infringement compensation,[20] damages for breach of contract,[21] and damages for the violation of the antitrust laws.[22] These six provisions are generally referred to as the spread-back provisions and were enacted in an attempt to protect certain taxpayers from one of the idiosyncrasies of the graduated income tax; that a person in a high bracket for one year will pay more taxes than the person who earned the same amount of money, but who earned it over several years.[23]

The most frequently encountered provision was section 1301 which was concerned with compensation for personal service. This section was recently repealed by the Revenue Act of 1964, and to avoid confusion with the provisions of the Revenue Act of 1964, will hereinafter be referred to as the spread-back provision.[24] Under the spread-back provision and its predecessor, section 107(a) of the 1939 Code, a taxpayer, who received more than eighty per cent of the total compensation from employment which covered a period in excess of thirty-six months, was entitled to limit his tax liability to an amount no greater than the aggregate of taxes which would have been payable had the compensation (the bunched income) been reecived ratably over the period of employment.[25] The operation of this and the other five spread-back provisions gave rise almost immediately to the problem of what effect these provisions had on adjusted gross income for prior years and the year of receipt: was adjusted gross income for the prior years increased to include the additional income? Was adjusted gross income for the current year reduced to show the spread-back, or did it remain the same? These and other questions, relating to the effect of spread-back income on deductions for prior and present years, can best be answered by a comparison of the three major cases in this area and the specific rules that each case promulgates.

In *Edward C. Thayer*,[26] the taxpayer sought to limit his adjusted gross income, for the purpose of computing his medical deduction, to an amount which included only that portion of the long-term compensation allocable to the current year.

The taxpayer contended the remainder of the "bunched" income was allocable, under section 107(a), to prior years and therefore should not be used to limit his current medical deduction.[27] The Commissioner

17. INT. REV. CODE OF 1954, § 1301, ch. 736, 68A Stat. 334 (1954).
18. INT. REV. CODE OF 1954, § 1302, ch. 736, 68A Stat. 335 (1954).
19. INT. REV. CODE OF 1954, § 1303, ch. 736, 68A Stat. 335 (1954).
20. INT. REV. CODE OF 1954, § 1304, ch. 804, 69 Stat. 688 (1955).
21. INT. REV. CODE OF 1954, § 1305, Pub. L. 85–165, 71 Stat. 413 (1957).
22. INT. REV. CODE OF 1954, § 1306, Pub. L. 85–866, 72 Stat. 1646 (1958).
23. *Supra* note 1.
24. INT. REV. CODE OF 1954, § 1301, ch. 736, 68A Stat. 334 (1954).
25. *Ibid.*
26. 12 T.C. 795 (1949).
27. Since the medical deduction is based on a certain percentage in excess of adjusted gross income (INT. REV. CODE OF 1954, § 213) it is to the taxpayer's favor to report as low an adjusted gross income as possible.

included in adjusted gross income the entire compensation received in the tax year in question and allowed only that part of the medical deduction which represented an excess of five per cent of this recomputed figure.[28] The tax court held for the taxpayer and said that bunched income should be considered for purposes of computing the medical deduction as if received ratably over the years, and only part of the income should be included in adjusted gross income.[29] Shortly after this decision the Commissioner acquiesced in the tax court's interpretation of section 107(a) of the 1939 Code.[30]

In *Wilkinson v. United States*,[31] the taxpayer computed his charitable deduction based on an adjusted gross income which included the entire amount of his spread-back income, even though he limited his tax by spreading back part of his income under section 107(a) into prior years. The Commissioner asserted that the adjusted gross income for the purposes of computing the charitable deduction was to be the adjusted gross income for the current tax year plus that portion of the spread-back income allocated to the current year.[32] The Commissioner contended, under the theory of the *Thayer* case, that the taxpayer should exclude that portion of the bunched income received in the current year, but allocated to prior years under the provisions of section 107(a).[33] The Court of Claims rejected the Commissioner's contention and stated that the taxpayer was entitled to compute the allowable charitable deduction on gross income including the bunched income, even though tax liability for the current year was limited to what it would have been had the compensation been paid ratably over the period during which the income was earned.[34]

The last in the series of cases concerning the effect of the now repealed section 107(a) and the spread-back provision on deductions limited by adjusted gross income was *United States v. Behle*.[35] In this case the taxpayer attempted to use the theory of the *Wilkinson* case to justify a large charitable deduction, while limiting his tax under, the spread-back provisions passed in 1954.[36] The district court agreed with the taxpayer, but the Court of Appeals for the Tenth Circuit reversed citing the *Thayer* case, and the legislature's apparent approval of the *Thayer* decision's construction of section 107(a) which was reenacted in 1954 as the spread-back provision. The court indicated the purpose of the spread-back provision was to put the taxpayer in the same position he would have been if his compensation was earned ratably over the years.[37] This being so, the court concluded that only the compensation allocated to the current year should

28. Edward C. Thayer, 12 T.C. 795, 797 (1949).
29. *Ibid.*
30. 1950-1 CUM. BULL. 5.
31. 304 F.2d 469 (Ct. Cl. 1962). See Notes: 62 COLUM. L. REV. 1342 (1962); 15 STAN. L. REV. 365 (1963); 17 U. MIAMI L. REV. 638 (1938).
32. *Id.* at 471.
33. *Ibid.*
34. *Id.* at 472.
35. 316 F.2d 134 (10th Cir. 1963). See note 38 N.Y.U.L. REV. 992 (1963).
36. *Id.* at 135.
37. *Id.* at 136.

be used for computing the charitable deduction for the current year.[38] The court was apparently concerned with the possibility that if a contrary position were adopted, the taxpayer would be allowed to increase his charitable deductions for the years to which the income was to be spread-back, and therefore limit his tax liability for these years while also getting a large charitable deduction in the current year thereby reducing taxes due in the current year.[39]

The *Thayer* rule admittedly appears equitable enough when applied to a situation in which the taxpayer, for purposes of making certain income tax deductions, desires a low adjusted gross income, but the inequities of the rule become obvious when applied to a situation such as is presented in the *Behle* case, where the taxpayer desires a large adjusted gross income.[40] It is highly unlikely that a taxpayer would be in a position to make large charitable contributions while performing services for which he is to be paid at a later date, with a view towards later spreading back the receipt of the money so as to secure the benefit of the prior charitable contribution.

If the courts continued to follow *Thayer* and *Behle* in cases involving charitable deductions, the taxpayers would either lose the benefit of a full deduction or make no charitable contribution. It appeared that some sort of legislative help was necessary. This help came; Congress in 1962 passed a charitable election section.[41] In enacting this section, Congress apparently saw that the decision in the *Thayer* case represented the proper judicial interpretation of the spread-back provisions, and that the *Wilkinson* rule, though equitable, was an improper interpretation of the statute.[42] The charitable election section gave relief to a taxpayer who was caught in a *Wilkinson-Behle* type situation, by permitting the taxpayer to increase his allowable charitable contributions deduction by subtracting from his gross income, in the year of receipt, that portion of the charitable contributions attributable to the bunched income before the spread-back provision is utilized.[43]

It can be seen from the above that discounting the effect of the *Wilkinson* case because of the passage of the charitable election section, some general rules may be formulated from the *Thayer* and *Behle* cases which will alleviate some of the difficulties characteristic in applying the spread-back provision. These rules would apply to income earned or accrued prior to December 31, 1963.[44]

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38. *Ibid.*
39. *Ibid.*
40. The reason for this is § 170 of the 1954 Code concerning charitable contributions which limits the deduction to a certain percentage of adjusted gross income; whereas, § 212 of the Code limits the deduction for medical expenses to a figure which is in *excess* of a certain percentage of adjusted gross income. The taxpayer in order to get maximum deduction needs a high adjusted gross income under § 170 and a low adjusted gross income under § 212.
41. INT. REV. CODE OF 1954, § 1307(e), ch. 736, 76 Stat. 1064 (1962).
42. S. REP. No. 1881, 87th Cong., 2d Sess. 127–28 (1962).
43. INT. REV. CODE OF 1954, § 1307(e), ch. 736, 76 Stat. 1064 (1962).
44. Revenue Act of 1964, § 232(g), Pub. L. No. 272, 88th Cong., 2d Sess., § 232(g) (Feb. 26, 1964).

Rule 1. For charitable contributions, determine if the taxpayer has elected to use the charitable election section. If he has, reduce the income to be spread-back accordingly.

Rule 2. If no charitable election was made, and the requirements of the spread-back provision[45] are met, allocate the bunched income to the applicable years (both prior and current years).

Rule 3. Recompute the tax for prior years as if the spread-back income were a part of the prior years' income. This would include recomputation of all deductions which would be effected by a new adjusted gross income, such as medical and charitable deductions.[46] This would also include investigation to determine whether any possible bad debt recovery benefit, or adjustment for depreciation as envisioned by sections 111 and 1016(a)(2) respectively would be involved.

Rule 4. Compute the tax due for the current year including therein only the amount of bunched income attributable to the current year. Add to this figure the tax which would have been due under rule 3 if the spread-back income had been included in the prior year.[47]

Rule 5. Compute the tax due in the current year without regard to the spread-back provision. If this figure is greater than the total tax due under rule 4, pay the tax due under rule 4.

It can be readily seen that the prior years' adjusted gross income will be increased to include the additional spread-back income, and that the current year's adjusted gross income will be reduced because of the spread-back. If the courts, the government and the taxpayers follow the above rules the major defects of the spread-back provision can be eliminated.

III.

THE REVENUE ACT OF 1964

The Revenue Act of 1964 represents the first legislation which provides an income averaging provision that is available generally to any taxpayer whose income fluctuates.[48] Prior Internal Revenue Code provisions concerning spread-back of income are deleted and are replaced with "income averaging" sections.[49] This latest tax relief measure is designed to treat everyone as nearly equal as possible without regard to the type of income involved or how the taxpayer's income is spread over a period of years.[50] Unlike prior statutory averaging provisions, all computations are to be made within the current tax year, which is designated the "computation

45. There was more than one spread-back section (§§ 1302 to 1306), but most of the litigation has involved § 1301.

46. In United States v. Behle, 316 F.2d 134, 136 (1963), the court stated: "The allocation back necessarily adjusts the amount of allowable charitable deductions in each prior year. . . ."

47. INT. REV. CODE OF 1954, § 1301(a), ch. 736, 68A Stat. 334 (1954).

48. S. REP. No. 830, 88th Cong., 2d Sess. 139 (1964).

49. Revenue Act of 1964, § 232(a) (1964), Pub. L. No. 272, 88th Cong., 2d Sess. § 232(a) (Feb. 26, 1964).

50. Prior provisions were limited to six categories as indicated *infra* at note 17 and could only be applied if money were earned over a specified number of months.

year." There is no recomputation of the prior year's taxes. The new act seeks to levy the tax in the same manner as if the bunched income were earned equally over the past five years.[51]

Under the averaging provisions of the new act the taxpayer is permitted to average all types of income except capital gains, wagering gains, income from gifts and bequests, and premature distributions received by owner-employees under a pension plan.[52] Averaging is available only where the "averagable income" exceeds $3,000[53] because it was believed that any sum less than this would achieve only minor benefit from an averaging procedure.[54] In the case of taxpayers filing a joint return, the $3,000 limitation applies to their combined averagable income.[55] "Averagable income" is defined under the act as "the amount (if any) by which adjusted taxable income exceeds 133⅓ percent of average base period income."[56] Adjusted txable income is taxable income for the current year adjusted for capital gains, income from gifts, and wagering income.[57] Average base period income is one-fourth of the sum of the incomes for the past four years.[58]

After it is determined that there exists averagable income, and that it exceeds $3,000, then the relief provisions of section 1301 may be applied. Section 1301 dictates that "the tax imposed by section 1 for the computation year shall be five times the increase in tax under such section which would result from adding 20 percent of such income . . ." to ". . . 133⅓ percent of average base period income. . . ."[59] This may sound confusing, but actually it is relatively easy to apply, as is demonstrated in the footnotes.[60]

Although section 1301 affords substantial tax saving to the taxpayer with fluctuating income, there still exist several problems which the statute did not reach, and several problems which it created. Since section 1301

51. S. REP. No. 830, 88th Cong., 2d Sess. 141 (1964).
52. INT. REV. CODE OF 1954, § 1302(b).
53. INT. REV. CODE OF 1954, § 1301.
54. S. REP. No. 830, 88th Cong., 2d Sess. 141 (1964).
55. INT. REV. CODE OF 1954, § 1304(d).
56. INT. REV. CODE OF 1954, § 1302(a)(1).
57. INT. REV. CODE OF 1954, § 1302(b).
58. INT. REV. CODE OF 1954, § 1302(c). Slight adjustments similar to those made in the income of the computation year are made to the incomes of these four years. See § 1302(c) for details.
59. INT. REV. CODE OF 1954, § 1301.
60. The following is a hypothetical situation utilizing §§ 1301 and 1302.

(1) Taxable income adjusted as required for capital gains, wagering income and gifts for the past four years and the current year:	
1960	$ 3,000
1961	2,500
1962	3,000
1963	3,500
1964	19,000
(2) Average base period income (1960–63)	$ 3,000
Adjusted Taxable income computation year	19,000
(3) Averagable income:	
Adjusted taxable income	$19,000
133⅓ percent average base income	4,000
	$15,000

operates only within the current year, it is possible that the taxpayer may not receive any deduction for medical expenses. Section 213 of the 1954 Code would limit the medical deduction to expenses in excess of three per cent of the adjusted gross income. Needless to say it would be virtually impossible to have any excess if the taxpayer has a large income in the current year. It is suggested that a new provision be adopted which would allow taxpayers electing to use section 1301 to use one-fifth of the averagable income plus the average base income instead of adjusted gross income as the limiting factor in applying section 213.

The statute failed to recognize that some income may be earned over a period exceeding five years, and that to average these incomes over five years is inequitable.[61] Since the spread-back provisions were repealed by the Revenue Act of 1964, the taxpayer has no recourse but to pay the additional tax. It is recognized that these individuals are probably in the minority and that it is impossible to satisfy everyone, but this is a real problem for which there is no solution under the present statute. Perhaps the spread-back provisions could have been made optional rather than have been repealed.

The present statute also lays a trap for the unwary taxpayer who makes substantial charitable contributions in the year of receipt of the extra income.[62] The charitable contributions may drop his taxable income below 133⅓ percent of his average base income. Such a situation could be avoided by warning the taxpayer to watch the amount of his contributions. It is possible that taxable income may fall below 133⅓ percent of average

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(4) Since averagable income ($15,000) does exist, and it is in excess of $3,000, the relief provision of § 1301 may be used.

(5) Section 1301 requires taking 20% of $15,000, which is $3,000 and adding this to 133⅓% of the average base period income ($4,000); this amounts to $7,000.

(6) Next, compute the increase in tax over the average base period tax attributable to the inclusion of one-fifth of averagable income:

Tax on $7,000	$ 1,480
Tax on $4,000 (133⅓% of average base period income)	740
Tax attributable to one-fifth of averagable income	$ 740

Assume standard deduction and single taxpayer.

(7) Multiply by five the tax attributable to one-fifth of the averagable income, (this represents the additional tax due on the averagable income, over and above the tax due on the average base income), and add this figure to the tax due on the base income not subject to averaging. This represents the tax liability in the current year.

Tax attributable to one-fifth	$ 740
Times 5	3,700
Tax due on base income	740
Tax due on averagable income	3,700
Tax liability for current year	$ 4,400

If § 1301 did not apply, the tax on $19,000 would have been $5,975. There is a tax saving here of $1,575.

61. S. REP. No. 830, 88th Cong., 2d Sess. 140 (1964).

62. 38 N.Y.U.L. REV. 992, 1001, n.52 (1963).

base income where there is only a minor fluctuation in income from year to year, but in that case there is no real need for the averaging provisions.

Because of the unique wording of section 1301, the amount of the taxpayer's saving will depend on the prior year's average income, and upon the degree of increase in the current year's income. This is not a defect in the statute, and is in fact one of its strong points because the purpose of the income averaging provisions is to help those taxpayers whose incomes fluctuate. Another advantage of the statute is the almost assured predictability of result if the taxpayer elects to use the provisions of section 1301.

IV.

CONCLUSION

The proposed rules concerning the spread-back provisions have left untouched all the problems which involved matters better achieved through legislation, rather than by a broadening of interpretation of existing law. But it is hoped that the suggested solution, of limiting tax in the current year to the tax based on a theoretical return for prior years, will provide a workable standard for the taxpayer and the Internal Revenue Service. The new provisions in the Code relating to income averaging make it evident that everyone will be treated as nearly equal for tax purposes as is possible.[63] There is now a provision which is workable from the standpoint of the taxpayer and the Internal Revenue Service[64] — a provision for computing taxes which is not unduly complicated.[65] It is also apparent that under the new statute the amount of the taxpayer's saving will depend on the prior years' average income and upon the degree of increase in his current income. There remains a possible inequity in the area of medical deductions and income which has been earned over a period in excess of five years.[66] These inequities must be remedied through new legislation,[67] and cannot be alleviated by judicial interpretation of the new income averaging provisions.[68] Nevertheless, the new income averaging provision of the Revenue Act of 1964 is a step forward in equalizing the tax burden of individuals whose incomes fluctuate widely from year to year.

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63. The old provisions of the Internal Revenue Code contained six specific averaging provisions dealing with special types of situations. The new income averaging provisions can possibly apply to anyone with income over $3,000 which is in excess of 133⅓ percent of his average base income. INT. REV. CODE OF 1954, § 1301.

64. The new averaging provision contains no such concept as adjusted gross income over which the taxpayer and the Service may disagree.

65. The new averaging provision does not require that the prior year's income and taxes be recomputed; it is concerned solely with the current tax year.

66. See text at note 61 *supra*.

67. Legislation similar to the old § 1307(e), concerning charitable deductions, could be easily passed to alleviate these problems.

68. The new income averaging provision is fairly clear as to what is permissible under the Code section and what constitutes averageable income, and in this writer's opinion, will not be subject to the extremely broad interpretation by the courts that the old § 107(a) of the 1939 Code and its successor under the 1954 Code underwent.