Washington and Lee Law Review

Volume 18 | Issue 1 Article 7

Spring 3-1-1961

Tax Aspects Of Contributions To Employees' Trust Funds

Follow this and additional works at: https://scholarlycommons.law.wlu.edu/wlulr

Part of the Estates and Trusts Commons, and the Tax Law Commons

Recommended Citation

Tax Aspects Of Contributions To Employees' Trust Funds, 18 Wash. & Lee L. Rev. 69 (1961), https://scholarlycommons.law.wlu.edu/wlulr/vol18/iss1/7

This Comment is brought to you for free and open access by the Washington and Lee Law Review at Washington & Lee University School of Law Scholarly Commons. It has been accepted for inclusion in Washington and Lee Law Review by an authorized editor of Washington & Lee University School of Law Scholarly Commons. For more information, please contact lawref@wlu.edu.

CASE COMMENTS

TAX ASPECTS OF CONTRIBUTIONS TO EMPLOYEES' TRUST FUNDS

Two vexing problems have arisen as by-products of an employer's contribution of real estate or other non-liquid assets to his employees' pension trust when they are *not* made pursuant to an approved plan.[1] These problems are: (1) May the employer take an income tax deduction for such a contribution, and if so, is the measure of the deduction the present fair market value of the property or the basis[2] of the property in his hands? (2) If a deduction is allowed to the extent of the present value of the property, does the employer owe a capital gains tax on the appreciation in value?[3]

The recent case of *United States v. General Shoe Corp.*[4] presented both of the above questions. The defendant owned real estate with a fair market value in 1951-52 that was considerably greater than its cost.[5] Although he was not legally obligated to do so, the defendant contributed the real estate to an employees' pension trust and deducted the fair market value on its income tax return for the taxable years of 1951-52. The Commissioner of Internal Revenue disallowed the deductions on the ground that they were not allowable under section 165[6] of the Internal Revenue Code of 1939 and that even if they

---

[1]When contributions are made pursuant to a "plan" which has been approved by the Commissioner of Internal Revenue's office, then section 404 of the 1954 Internal Revenue Code pertaining to pension trusts is applicable and such contributions may be deducted as ordinary and necessary business expenses.

[2]The basis of an asset has roughly been defined as its cost plus capital improvements less any depreciation allowed or allowable.

[3]Appreciation is represented by the difference between the basis of the property in the hands of the donor and its fair market value at the time of transfer.

[4]282 F.2d 9 (6th Cir. 1960), reversing CCH 1959 Stand. Fed. Tax Rep. (59-1 U.S. Tax Cas.) ¶ 9178 (M.D. Tenn. Jan. 13, 1959).

[5]The fair market value of the property involved was disputed in the District Court, but the determination that the defendant's contention was sound was not contested on appeal.

[6]Revenue Act of 1936, § 165, added by ch. 619, 56 Stat. 862 (1942), (now Int. Rev. Code of 1954, §§ 401-404). These code sections relate to employee stock bonus, profit sharing, and pension trust plans. Requirements for these programs are spelled out so that contributions made to them will be deductible as ordinary and necessary business expenses as provided by other related code sections and at the same time be nontaxable as income to the employee. The Revenue Act of 1936, § 165 was readopted as Int. Rev. Code of 1939, § 165, ch. 1, 53 Stat. 67 (1939).

were allowable, the defendant owed a capital gains tax on the difference between the fair market value of the property on the date of transfer and the basis. The District Court[7] held for the taxpayer in both instances, but the Court of Appeals for the Sixth Circuit reversed, holding that the defendant was entitled to a deduction but owed the capital gains tax demanded by the Commissioner.

In order to understand the situation involved, it is first necessary to consider the nature of pension trusts. While employers have sought to reward their employees with larger incomes and benefits for many years, modern pension planning did not begin until 1942. The Revenue Act of 1942[8] provided for deferred compensation to the employee and also continued to permit an employer to deduct as an ordinary and necessary business expense[9] the amounts contributed to any plan in the nature of a trust to supplement employees' income when they reach retirement age. However, it added the provision that "the employee pays no tax on the employer's contribution until he actually receives the money, and then the payment will be taxed only at the capital gain rate if his share is paid out within a single year on account of his separation from the service of the employer. If the employee [as well as the employer] has contributed to the plan fund, and periodic payments are made to him after retirement, his contributions are returned to him tax free by averaging a deduction for these contributions against his life expectancy."[10] Only those pension trusts that "qualify" by conforming to specifications spelled out by the Internal Revenue Code[11] and in the regulations[12] are entitled to

---

[7]General Shoe Corp. v. United States, CCH 1959 Stand. Fed. Tax Rep. (59-1 U.S. Tax Cas.) ¶ 9178 (M.D. Tenn. Jan. 13, 1959).

[8]Revenue Act of 1936, § 165, added by ch. 619, 56 Stat. 862 (1942) (now Int. Rev. Code of 1954 § 404). Prior to 1942, § 165 of the Internal Revenue Code related only to nontaxability of the income received by penson trusts.

[9]Employer contributions to pension trusts were first allowed as deductions for ordinary and necessary business expenses by the Revenue Act of 1928, § 23(q), ch. 852, 45 Stat. 802 (1928). This provision was substantially reenacted in the Int. Rev. Code of 1939, § 23(p), ch. 1, 53 Stat. 15 (1939) (now Int. Rev. Code of 1954, § 404(a)).

[10]1 CCH Pension Plan Guide ¶ 306 (1960). The provision specifically relating to the treatment of payments received by an employee pursuant to a qualified pension plan may be found in the Int. Rev. Code of 1939, § 165(b) and (c), added by ch. 619, 56 Stat. 863 (1942) (now Int. Rev. of 1954, § 402(a)).

[11]Int. Rev. Code of 1939, § 165(a), added by ch. 619, 56 Stat. 862 (1942) (now Int. Rev. Code of 1954 § 401(a)).

[12]Treas. Reg. §§ 1.401-1 through 5 (1956). The regulations pertaining to Int. Rev. Code of 1939, § 165 are cited as Treas. Reg. 111 §§ 29.165-1 through 5. When the Treasury Regulations were promulgated they incorporated many Revenue Rulings and similar pronouncements by the Commissioner of Internal Revenue of what he thought the law was pertaining to pension trusts prior to the effective date of the regulations.

this special treatment. It was originally thought that one of the requirements for such a plan was that contributions must be made on a periodic basis pursuant to some fixed obligation of the employer.[13] However, the 1951 case of *Lincoln Electric Co. Employees' Trust v. Commissioner*[14] held that such an obligation or plan was not a necessary prerequisite for contributions to employee pension trusts to be deductible under section 23(p) of the 1939 Code.[15] The Court of Appeals in the instant case specifically followed the *Lincoln Electric* decision and held the contributions deductible as an ordinary and necessary business expense.[16]

Once it was determined that the General Shoe Company was entitled to a business deduction, the amount of the deduction became the issue in controversy—the Commissioner contending that it should be limited to the basis of the property in the donor's hands, and the taxpayer taking the position that it should be the fair market value of the property on the date of transfer. In other areas of tax law, fair market value has been held to constitute the basis of business deductions[17] and a close analogy to the situation in the principal case may

---

[13]It is not a necessary condition to the "qualification" of an employees' trust that the plan establishing the trust include a fixed or predetermined formula for determining the amount of an employer's contribution. McClintock-Trunkey Co. v. Commissioner, 217 F.2d 329 (9th Cir. 1954); Commissioner v. Produce Reporter Co., 207 F.2d 586 (7th Cir. 1953); Lincoln Electric Co. Employee's Profit-Sharing Trust v. Commissioner, 190 F.2d 326 (6th Cir. 1951); Treas. Reg. § 1.401-1(b)(1)(ii). Corresponding regulations under the 1939 Internal Revenue Code have been retroactively amended to conform to the regulations in this area under the Internal Revenue Code of 1954 in T.D. 6189, 1956 Cum. Bull. 972. Earlier Revenue Rulings on the same point have been modified in Rev. Proc. 56-22, 1956-2 Cum. Bull. 1380 and Rev. Rul. 56-366, 1956-2 Cum. Bull. 976.

[14]190 F.2d 326 (6th Cir. 1951).

[15]See statutes cited at note 9 supra.

[16]The Lincoln Electric case was decided under Int. Rev. Code of 1939, § 165. Pursuant to that section, employer contributions to employee pension trusts were deductible as a general business expense. However, Int. Rev. Code of 1954 specifically states that such contributions are not to be deducted under § 162 pertaining to general business expenses or § 212 relating to expenses for the production of income but must be deducted under § 404(a) as a separate category of business expenses. See also, Commissioner v. Surface Combustion Corp., 181 F.2d 444 (6th Cir. 1950).

Because the contributions in the principal case were gratuitous, the further possibility arose that they might be deductible under Int. Rev. Code of 1954, § 162 (substantially the same as Int. Rev. Code of 1939, § 23) which pertains to general business expenses. It has been held that gifts from which even slight benefit may be expected are so deductible. Spang-Chalfant & Co., 9 B.T.A. 858 (1927) (nondeductible); Live Stock Nat'l Bank, 7 B.T.A. 413 (1927); Treas. Reg. § 1.162-15 (1958). For an excellent discussion in this area see 4 Mertens, Federal Income Taxation § 25.115 (1954). In its opinion the court did not investigate this possibility because it sought other grounds upon which to base its decision.

[17]Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954); White v. Brodrick, 104 F. Supp. 213 (D. Kan. 1952); Package Mach. Co., 28 B.T.A. 980 (1933) (basis of stock

logically be drawn. This analogy must have been persuasive since the court cited no authority[18] for sustaining the defendant's position.

The disposition that was made of these points inevitably led the court to a question that had not been faced for seventeen years.[19] That is, must the taxpayer pay a capital gains tax on the difference between the fair market value of the property transferred and the basis of that property in the hands of the donor? In order for a capital gains tax to be allowed or required, the conditions of sections 1001 and 1002[20] of the 1954 Internal Revenue Code must be met. The pertinent parts of these sections are as follows:

> Section 1001
> "(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the *amount realized* therefrom over the adjusted basis provided in section 1011 for determining gain....
> (b) Amount Realized. —The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received...."
> Section 1002
> "Except as otherwise provided in this subtitle, on the *sale or exchange* of property the entire amount of the gain or loss, determined under section 1001, shall be recognized." (Emphasis added.)

The court could plausibly have ruled that the facts of the *General Shoe* case did not technically comply with either of the above quoted sections. It is difficult to find that there was "an amount" realized, as required by section 1001. The taxpayer did not receive a fund of money in return for the surrendered property, nor was any fixed obligation extinguished, nor did he receive any tangible "property." However, the court, taking a realistic approach, stated that the tax-

---

issued as compensation is fair market value when issued); Treas. Reg. § 1.170-1(c) (1958) (fair market value at date of transfer is measure of charitable contribution).

[18]It is interesting to note that while the General Shoe case was pending the Tax Court also held that fair market value is the proper measure of a deduction allowable to the donor of property to a pension trust. Colorado Nat'l Bank, 30 T.C. 933 (1958).

[19]The only previous case which had faced these identical issues was International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943) in which Judge Frank wrote an opinion with which Judges Learned Hand and Chase concurred. In that case it was held that a capital gains tax was payable on the appreciation of stock transferred to employees as a bonus for services rendered.

[20]Int. Rev. Code of 1954, § 1001 is the same as Int. Rev. Code of 1939, § 111, ch. 1, 53 Stat. 27 (1939).

payer realized his "money's worth"[21] in making the transfer of property and equated that phrase with "amount realized." By first accepting, as the court did, that "the tax statutes do not operate in theory—they are practical,"[22] such an equation becomes entirely valid. Other cases have held that the taxpayer received his "money's worth" in related situations,[23] and the use of the same analogy in the present situation does not appear incorrect. Judge Thornton, in the court's opinion, forthrightly stated that the decision stepped outside the letter of the law:

> "The theory of economic gain comes into play. To argue, as the taxpayer does here, that there can be no gain because nothing is realized, is unrealistic. *Literally* the taxpayer is correct in its contention that it did not receive a tangible benefit... however, we do not conceive that in this day and age we are restricted to tangibles in tax matters where there is actual recognizable benefit, albeit intangible, the taxation of which is implicit in the statutory scheme, and where such benefit is clearly capable of being evaluated on an objective basis."[24]

It is clear from the court's opinion that the *General Shoe* case stands on the reasoning of *International Freighting Corp. v. Commissioner*[25] which held that a company had "realized an amount" equal to the fair market value of stock transferred to its employees when such stock was intended to be a bonus for services rendered. *Freighting*

---

[21]The court felt that the taxpayer was receiving the intangible benefits of employee loyalty, added desire to do good work, and the possibility of not having to pay additional wages when it transferred the property involved to an employee pension trust. It was therefore held that the taxpayer received his "money's worth" for the property.

[22]United States v. General Shoe Corp., 282 F.2d 9, 12 (6th Cir. 1960).

[23]The phrase, "money's worth" seems to have had its beginning in Helvering v. Horst, 311 U.S. 112, 117 (1940) which distinguished Blair v. Commissioner, 300 U.S. 5 (1937), and compare Burnett v. Leininger, 285 U.S. 136 (1932) and Lucas v. Earl, 281 U.S. 111 (1930). The same phrase again appeared in Commissioner v. Mesta, 123 F.2d 986, 988 (3d Cir. 1941), cert. denied, 316 U.S. 695 (1942), rehearing denied, 317 U.S. 704 (1942), wherein it was said, "We think that we make the practical assumption that a man who spends money or gives property of a fixed value for an unliquidated claim is getting his money's worth." Subsequently other cases were decided which used the same line of reasoning, e.g., Commissioner v. Halliwell, 131 F.2d 642 (2d Cir. 1942), cert. denied, 319 U.S. 741 (1943); Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940); King, 31 T.C. 108 (1958); Hall 9 T.C. 53 (1947); Rev. Rul. 57-507, 57-2 Cum. Bull. 511.

See also Lucas v. Ox Fibre Brush Co., 281 U.S. 115 (1930) which dealt with the reasonableness of "gratuitous" bonuses as compensation. In that case the taxpayer alleged that the bonuses should be deductible since he received the same advantages he would have enjoyed had he paid the money in salaries.

[24]United States v. General Shoe Corp., supra note 22, at 12 (Emphasis added.)

[25]135 F.2d 310 (2d Cir. 1943).

leans heavily upon the authority of *Commissioner v. Mesta*[26] which held that an individual "realized an amount" equal to the fair market value of property transferred to his estranged wife pursuant to a divorce decree. In May 1960, the same Court of Appeals that decided the *General Shoe* case decided the case of *Commissioner v. Marshman*[27] which involved facts similar to those in *Mesta* but reached a result opposite from *Mesta*. Therefore, unless *Marshman* could be effectively distinguished from *Mesta, General Shoe* would appear to stand on unsecure ground. In *General Shoe,* the Sixth Circuit did not try to distinguish *Marshman* from *Mesta,* but distinguished both cases from *Freighting* on the ground that they were divorce cases while *Freighting* involved employee-employer relations.[28] It may be concluded that this court accepted the decision of *Freighting* but refused to concur with the authority it cites as controlling.

Turning to section 1002, it is apparent that section 1001 cannot be applied unless there is a "sale or exchange." It is curious that this point was not raised because it does not necessarily follow that an "amount realized" can only arise from a sale or exchange.[29] Whereas, "the terms 'sale' and 'exchange,' except as modified by statute [for taxation purposes] are to be considered in the light of their ordinary meaning,"[30] it may not be said that the cases arising out of tax disputes derived a definition of "sale" or "exchange" synonymous with the definition which evolved from the common law.[31] This difference of approach is illustrated by the possibility that there may be a "sale" or "exchange" for taxation purposes even without consideration or an

[26]123 F.2d 986 (3d Cir. 1941).

[27]279 F.2d 27 (3d Cir. 1960). This case held that petitioner was not liable for a capital gains tax when he surrendered to his estranged wife the right to purchase $400,000 worth of stock for $40,000 in a divorce proceeding. The court reasoned that the husband had not realized a taxable "amount" because what he received for the right to purchase the stock was not necessarily $360,000 ($400,000-$40,000), the fair market value of the transaction, but some indeterminable benefit that one receives from being divorced.

[28]It is noted that Mesta, Marshman and Halliwell all involved property settlements in divorce proceedings whereas Freighting dealt with arms' length transactions between an employer and his employees.

[29]E.g., gift and inheritance.

[30]3B Mertens, Federal Income Taxation § 22.92 (1954). For a collection of cases which have at least paid lip service to this proposition see note 80 following § 22.92.

[31]Whereas this comment does not attempt to define the elusive term "sale" as derived from the long history of exchange transactions between people dealing at arms' length, it is generally conceded that a sale is traditionally thought of as a contract which necessarily implies a consideration. Vold, Sales 65 n.62 (2d ed. 1959).

amount realized.[32] However, once the court found a consideration in "money's worth," it simply assumed that the sum total of the transaction resulted in a sale or exchange within the meaning of section 1002 and forthwith found a capital gains tax due. Although the assumption that a sale or exchange occurred is probably valid, the opinion of the court would have been more complete if the rationale of the assumption had been given.

While the court made a tenable statutory interpretation in reaching its final conclusion, it is conceivable that the same court could have reached an opposite conclusion by using section 170 of the Internal Revenue Code[33] which relates to deductions for charitable contritions.[34] From the outset, it must be remembered that a deduction allowable under section 170 is not to be confused with a deduction for business expenses; the charitable deduction is granted for an entirely different policy reason than the business deductions.[35] From a donor

---

[32]Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666 (1949), affirming per curiam, 115 F.2d 288 (8th Cir. 1940) held that a loss sustained by the taxpayer was a capital loss from a "sale or exchange" even though the taxpayer was under no obligation to accept the loss. Therefore the taxpayer was given the benefit of a "sale" without surrendering any consideration. See also Bert B. Burnquist, 44 B.T.A. 484 (1941); James B. Lapsley, 44 B.T.A. 1105 (1941); John A. O'Keefe, 44 B.T.A. 290 (1941). Compare W. W. Hoffman, 40 B.T.A. 459 (1939).

[33]Substantially the same as Int. Rev. Code of 1939, § 23(o) and (q), ch. 1, 53 Stat. 14-15 (1939).

[34]The pertinent parts of Int. Rev. Code of 1954 § 170 are as follows:

> "(a) Allowance of Deduction—
>
> (1) General Rule.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year....
>
> "(c) Charitable Contribution Defined—For purposes of this section, the term 'charitable contribution' means a contribution or gift to or for the use of—....
>
> (2) A corporation, trust, or community chest, fund, or foundation....
>
> (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals...."

There is a limitation put on corporate charitable contributions pursuant to Int. Rev. Code § 170(b)(2) of 5 per cent of taxable income for any one given year with a carry-over provision for the next two succeeding years.

[35]Whereas the deduction for business expenses is allowed so that the taxpayer does not have to pay a tax on that which is not truly income, but a return of capital, the charitable deduction is allowed to encourage private individuals and corporations to make donations to worthy organizations. Congress did not intend any overlap between the two provisions, as is shown by the following:

> "At the present time corporations are allowed a deduction for charitable contributions up to a limit of 5 percent of their income otherwise subject to tax. In addition, they are allowed to take as business-expense deductions contributions to charitable and other organizations where the institution is to render a service commensurate to the contribution. However, where

corporation's point of view, section 170 treatment of a donation is preferable to section 404(a) treatment of the same donation because there is no capital gains tax payable on the appreciation in the former situation.[36] Moreover, the precedent set in *Freighting* imposes such an obligation in the latter. There is, however, a common meeting ground on which sections 404(a) and 170 converge. That meeting ground is section 501[37] which exempts from federal income taxation certain enumerated classes of corporations, pension trusts being one class, and charitable corporations being another. If the policy which gave rise to the establishment of the charitable deduction permitted in section 170 were held to be the same policy which would encourage an employer to create a pension trust for the benefit of his employees, it would not have been unreasonable for the court to state that section 170 treatment was applicable in the *General Shoe* case. Strengthening this hypothetical argument that section 170 is applicable to the instant situation is a line of decisions arising out of taxation disputes holding that a fund for employees is a charitable organization so that its income is nontaxable.[38] The holding that these funds are charitable organizations for one purpose within the meaning of section 170 would be persuasive when another purpose is involved.

---

no service is rendered, a business-expense deduction may not be taken for amounts not allowable as charitable contributions only because they are in excess of the 5 percent limitation." H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 20 (1954).

[36]"Section 170(d) defines a 'charitable contribution' as a 'contribution or gift' without limiting the term to transfers of money, or to the cost basis in the donor's hands or other property transferred. Treasury Regulations construing similar sections in prior law have long recognized that the fair market value of property given to charity constitutes a deduction from the donor's income." U. So. Cal., 1957 Tax Inst. 707. In situations arising in this area, the Commissioner has not even asserted that a tax is payable on the appreciation of the donated property. Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1954); White v. Brodrick, 104 F. Supp. 213 (D. Kan. 1952); Champlin v. Broderick, CCH 1948 Stand Fed. Tax Rep. (1948-2 U.S. Tax Cas.) ¶ 9332; Treas Reg. § 1.170-1(c) (1956), formerly under Int. Rev. Code of 1939, § 23(o); Rev. Rul. 55-138, 1955-1 Cum. Bull. 223 (discussing methods to determine fair market value of property donated).

[37]Int. Rev. Code of 1954, substantially the same as Int. Rev. Code of 1938, § 101, ch. 1, 53 Stat. 32 (1939).

[38]Gimbel v. Commissioner, 54 F.2d 780 (3d Cir. 1931), citing Egan v. Commissioner, 43 F.2d 881 (5th Cir. 1930); Bok v. McCaughn, 42 F.2d 616 (3d Cir. 1930); Proctor Patterson, 34 B.T.A. 689 (1936), appeal dismissed, 90 F.2d 1016 (6th Cir. 1937); Young Men's Christian Ass'n Retirement Fund, Inc., 18 B.T.A. 139 (1929); John R. Sibley, 16 B.T.A. 915 (1929); G.C.M. 19028, 1937-2 Cum. Bull. 125. The charitable quality of similar organizations is destroyed if the beneficiaries themselves make a major portion of the contributions. Lindback Foundation v. Commissioner, 4 T.C. 652 (1945), aff'd, 150 F.2d 986 (3d Cir. 1945); E. Huddleston, 13 T.C.M. 395 (1954); Rev. Rul. 58-264, 1958-1 Cum. Bull. 144.