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1952

# Taxation; Deductibility of Corporate Contributions to a Group Annuity Policy and an Employee's Trust

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## Recommended Citation

Daniel R. McCarthy, Taxation; Deductibility of Corporate Contributions to a Group Annuity Policy and an Employee's Trust, 1(2) Clev.-Marshall L. Rev. 77 (1952)

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## RECENT DECISION

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### TAXATION; DEDUCTIBILITY OF CORPORATE CONTRIBUTIONS TO A GROUP ANNUITY POLICY AND AN EMPLOYEES' TRUST.

**I**N 1941 the petitioner, a manufacturing company, paid the sum of \$575,206.43 into a retirement annuity policy for its employees and contributed the sum of \$1,000,000.00 to an employees' trust. Held: Such payments constituted ordinary and necessary business expenses and were deductible under section 23 (a) (1) (A) of the Internal Revenue Code.<sup>1</sup> This was the case of *Lincoln Electric Company v. Commissioner of Internal Revenue*, 17 Tax Court 1600, decided March 26, 1952.

This was the fifth time that this case had been before the courts.

In order to get a comprehensive picture of the problems litigated, the following outline provisions of the annuity policy and the employees' trust should be noted.

#### **Outline of the Annuity Policy.**

*Name:* The Lincoln Electric Retirement Annuity Plan under a group annuity contract with the Sun Life Assurance Company of Canada.

*Year effective:* 1936.

*Eligibility requirements:* The minimum age for both male and female is 15 years, the maximum, 60 years. One year of service is also required.

#### *Contributions:*

- (1) Employee—none.
- (2) Employer—to be determined by the company at its discretion, however with a limitation of \$600,000.00 per year.

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<sup>1</sup>Internal Revenue Code Section 23 (a) (1) (A).

Trade or business. In general—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rental or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

*Benefits:*

- (1) Formula—retirement benefits are based on age, service and sex to be computed under tables in the policy.
- (2) Normal retirement age—upon reaching 60 years of age the employee retires and the annuity contract becomes vested.
- (3) Death benefits—normally none, however there are some exceptions.<sup>2</sup>
- (4) Forfeitures—to be allocated among other employees covered by the policy.

*Miscellaneous:* The policy also contained a provision that no part of the forfeitures or interest shall ever revert back to the Employer, but shall be used to pay future premiums.

**Outline of the Profit Sharing Trust.**

*Name:* The Lincoln Electric Company Employees' Profit Sharing Trust.

*Trustee:* The Cleveland Trust Company.

*Year Effective:* In December 1941, by resolution of the Board of Directors of the Company.

*Eligibility requirements:* All who were regular employees as of December 31, 1941 excluding salesmen, the company president, chairman of the board and the treasurer.

*Contributions:*

- (1) Employee—none.
- (2) Employer—a lump sum contribution of \$1,000,000.00 was contributed by action of the company in De-

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<sup>2</sup>The court (6 Tax Court) in commenting on the annuity plan stated: "In the event the employee dies or his employment is terminated for any cause other than disability, all his rights are forfeited except where the annuity already accrued for that employee is equal to his then annual salary or \$3,500.00 whichever is less. In the latter case, the accrued annuity becomes the property of the withdrawing employee and he has the right to exercise all the options and privileges inherent therein, except the right to assign any interest or benefit to which he may be entitled. The policy further provides that, in the event of the severance from employment before retirement age, "there shall become available on account of the contributions of the Employer allocated to such employee \* \* \* an amount equal to 90% of the total of such contributions together with interest at the rate of three and one-half per cent (3½%) per annum compounded annually, or the total of such contributions, whichever shall be the greater."

ember, 1941. There was no set formula for determining the contribution. No contributions were made before or after the initial payment.

*Benefits:*

- (1) Formula—proportion of the total fund represented by the ratio of his total cash compensation in the period January 6, 1941 to December 5, 1941, to the total compensation of the beneficiaries.
- (2) Duration—the fund is to vest in the participants at the end of ten years.

*Miscellaneous:* The plan was to be administered by a committee composed of three members. The president of the company was a member *ex officio*. The committee was vested with wide powers, to which the Tax Court took exception.<sup>3</sup> The plan provided that no distribution was to be made to or for the benefit of any beneficiary during the ten year period, except by the voluntary action of the committee. It also provided that no part of the corpus or income from the corpus could ever revert back to the company.<sup>4</sup>

The taxpayer claimed the contribution as an expense on its 1941 corporation income tax return.<sup>5</sup> An examination of the return by The Internal Revenue Agents Office resulted in the expense being disallowed. The taxpayer protested the findings and petitioned the Tax Court for a hearing. The decision was promulgated January 11, 1946.<sup>6</sup>

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<sup>3</sup> 6 Tax Court 37, Promulgated January 11, 1946.

<sup>4</sup> It is interesting to note that in *The Lincoln Electric Company Employees Profit Sharing Trust; The Cleveland Trust Company, Trustee v. Commissioner of Internal Revenue*, a collateral issue was considered as to the taxability of the trust. 14 Tax Court 598, Promulgated April 17, 1950. The court held the trust was not an exempt trust within the purview of section 165 (a) of the Internal Revenue Code. This decision was appealed by the petitioner and the United States Court of Appeals, Sixth Circuit held: "Under Internal Revenue Act provided that trust forming part of a stock bonus, pension or profit sharing plan of employer for the exclusive benefit of employees or their beneficiaries is exempt from taxation, income from irrevocable trust to which established plan to share definite portion of employer's profits with certain officers and employees by future distribution was exempt from taxation." 190 F. 2d 326 (6th Cir. 1951).

<sup>5</sup> The taxpayer filed its 1941 Federal income tax return with the Collector of Internal Revenue for the eighteenth district of Ohio, at Cleveland, Ohio.

<sup>6</sup> 6 Tax Court 37 (1946).

The respondent contended that such payments did not represent compensation, were not ordinary or necessary business expenses and, in some instances, did not represent reasonable compensation. The petitioner contended that the contributions were properly deductible either (a) as compensation paid for personal service actually rendered, or (b) if not such compensation, as an expense or (c) if not a deduction from gross income then merely a cost of goods to be reflected in the computation of gross income and that as to this respondent has no jurisdiction. The court sustained the determination of the Commissioner. On appeal the decision was reversed.<sup>7</sup> The United States Circuit Court of Appeals for the Sixth Circuit held that the premiums paid were ordinary and necessary expenses deductible under section 23 (a) (1) (A) of the Internal Revenue Code and remanded the case back to the Tax Court for a recomputation of the deficiencies.

Upon the first remand to the Tax Court, the Commissioner contended that since the Circuit Court had decided that the contributions were ordinary and necessary business expenses, it was within the jurisdiction of the Tax Court to decide the question of the reasonableness of the payments as compensation. The company argued that no such issue was present, and all that was necessary was a determination by the Tax Court of the deficiencies, if any, with an allowance of such deduction to the petitioner. The Tax Court held that it had no jurisdiction under the mandate as contended by the Commissioner since the Sixth Circuit Court directed that the deduction was allowable under section 23 (a), and therefore it was improper to consider whether or not they constituted compensation for personal services.

The Commissioner appealed, and the Sixth Circuit Court held<sup>8</sup> that the remand restored to the Tax Court all the authority it possessed when the case was first before it except that it was required to conform to the ruling of the Sixth Circuit Court of Appeals on the question of law and again remanded the case to determine reasonableness.

The present case was now before the court on the second mandate from the Sixth Circuit Court of Appeals. The sole issue that was decided was whether or not the amounts contributed to the annuity contract and the profit sharing trust were reason-

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<sup>7</sup> 162 F. 2d 379 (6th Cir. 1947).

<sup>8</sup> 176 F. 2d 815 (6th Cir. 1949); *cert. den.*, 338 U. S. 949 (1950).

able. The Tax Court in complying with the mandate held that the amounts were reasonable. Thus the company was entitled to deduct the contributions as ordinary and necessary expenses in carrying on its business under section 23 (a) (1) (A) of the Internal Revenue Code.

In view of the above decision it is interesting to note the comment the United States Circuit Court of Appeals for the Fourth Circuit in deciding *Robertson v. Steele's Mills*, a case similar in many respects.<sup>9</sup> The court in referring to the *Lincoln Electric* case stated: "The opinion of Circuit Judge Simons in the *Lincoln Electric* case, 162 F. 2d at page 384, contains an eloquent encomium of trusts created by employers for the benefit of employees. With that encomium we heartily agree. But the federal taxability of expenditures for these trusts does not depend upon their beneficence. Congress has furnished other criteria as determinative of taxability and these criteria we must follow and apply. Whether the ethical and economic excellences of these trusts should place them in a favored federal tax category is a problem for Congress and not for the Courts."

The Court with reference to the *Roberts Filter* case, cited *infra*, further stated: "Though the facts in the three cases are not identical, we think these cases are so similar that the same result should be reached in the instant case, in the *Roberts Filter* case and the *Lincoln Electric* case. Judge Arnold recognized the similarity between the *Roberts Filter* case and the *Lincoln Electric* case and, speaking for the Tax Court in the former case, flatly refused to follow the opinion of Judge Simons, speaking for the Circuit Court of Appeals for the Sixth Circuit, in the latter case. We prefer the reasoning in the *Roberts Filter* case as conforming more closely to that economic reality which is often said to be the very essence of tax legislation."

The case referred to in the above paragraph was *Roberts Filter Manufacturing Company, Petitioner v. Commissioner of Internal Revenue*.<sup>10</sup> The court in that case, in comparing it with the *Lincoln Electric* case, stated: "The problem here is similar in several respects. A fundamental principle of income tax law is the annual accounting of profits and losses. A taxpayer may not play good years against bad years by shifting income or expenses

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<sup>9</sup> 172 F. 2d 817, at 822 (4th Cir. 1949).

<sup>10</sup> 10 Tax Court 26 (1948).

from one year to another. To allow petitioner to take a deduction of \$40,000.00 for 1941 for an amount which is to be paid as compensation to its employees in subsequent years would result in a distortion of petitioner's net income for 1941. With all due deference to the Circuit Court, we adhere to the views we expressed in our decision in the cited case and prefer to follow that decision here."

The *Roberts Filter* case was appealed and the United States Court of Appeals for the Third Circuit sustained the Tax Court.<sup>11</sup> However it did attempt to distinguish the *Roberts Filter* case from the *Lincoln Electric* case.

It should be noted that the Commissioner has not acquiesced in the decision in the *Lincoln Electric* case.<sup>12</sup>

DANIEL R. McCARTHY

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<sup>11</sup> 174 F. 2d 79 (3rd Cir. 1949).

<sup>12</sup> A similar issue was involved in *Produce Reporter Company*, 18 Tax Court 8, decided April 10, 1952. The company pointed out that neither 165 (a) nor 23 (p) makes any mention of a definite predetermined formula, and this requirement is only contained in the commissioner's regulations. The Tax Court found for the company, but without considering the validity of the regulation.