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TAXATION-FEDERAL INCOME TAX-DEDUCTIBILITY OF CONTRIBUTIONS TO PROFIT-SHARING TRUSTS

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TAXATION—FEDERAL INCOME TAX—DEDUCTIBILITY OF CONTRIBUTIONS TO PROFIT-SHARING TRUSTS—Plaintiff corporation set up a profit sharing trust for the benefit of its employees as authorized under section 165(a) of the Internal Revenue Code. The plan for the trust, as approved by the Treasury,[1] provided that plaintiff should contribute annually an amount equal to 15% of net income, as defined,[2] not to exceed 15% of basic salary or wages of all eligible participating employees. For the tax year 1944 plaintiff claimed deductions under section 23(p)(1)(C) for an amount equal to 15% of the total participating payroll, which is actually the allowable maximum,[3] but which in this case exceeded 15% of the net income figure. The Collector of Internal Revenue reduced the allowable deduction to the latter amount and declared a deficiency, which the plaintiff paid. This action was brought in the federal district court to secure a refund. *Held,* the amount by which the contribution exceeded 15% of net profits was not authorized by the approved plan and did not constitute an allowable deduction as an ordinary and necessary business expense under the Internal Revenue Code. *Gross-Given Mfg. Co. v. Kelm, Collector of Internal Revenue,* (D.C. Minn. 1951) 99 F. Supp. 144.[4]

The policies, merits, limitations and procedures which surround the establishment, approval, and contributions to a pension or profit-sharing trust by a

[1] Approval of such trusts must be secured from the Pension Trust Division of the Treasury Department in order for contributions thereto to be deductible, unless the employee's rights, at the time of contribution, are non-forfeitable. See I.R.C., §§165(a), 23(p)(1); Treas. Reg. 111, §§29.165-1(a), (c), 29.23(p)-1, 29.23(p)-10, 29.23(p)-11.

[2] Actual net profits were to be reduced by 7½% of the invested capital of the company prior to figuring the 15% for determining the amount of contributions to be made.

[3] See I.R.C. §§23(p)(1)(C), 165(a).

[4] The court also held that deductions should be allowed to the full extent prescribed under the approved plan as computed using a net income, as defined (see note 2 supra), which had been adjusted to correct mathematical errors, rather than the net income figure as originally submitted by the company.

corporation for the benefit of its employees have been the subjects of many writings[5] and need not be pointed out here. The unique point in the principal case was the court's holding that the amount contributed in excess of 15% of net profits was not, in the absence of proof, an ordinary and necessary business expense. Clearly, all contributions must meet the section 23(a) "ordinary and necessary" test in order to be deductible under section 23(p).[6] Yet, a glance at section 23(p)(1)(C) shows that this section allows a deduction for contributions to a profit sharing trust up to 15% of the total participating payroll, which would seem to be a legislative determination of what is "ordinary and necessary," regardless of what any individual plan provides. The plaintiff argued that any additional limitations, such as "15% of net profits not to exceed 15% of total participating payroll," would be for the protection of an employer and could be waived by him if desired. Moreover, plaintiff contended[7] that the additional contribution was made to dissuade his employees from accepting jobs elsewhere. The plaintiff's case has considerable merit. It seems that contributions which exceed the statutory maximum have previously been dealt with as being "unreasonable" under section 23(a),[8] their "ordinary and necessary" nature having been usually taken for granted. "Reasonableness" would depend upon the nature and extent of other compensation which the employees receive. Contributions to the full statutory extent would seem to be both ordinary and necessary considering the fact that the maintenance of pension and profit-sharing trusts by corporations is quite common in the business world today. But the position of the Treasury[9] and the Tax Court in other cases[10] seems to be that the ordinariness and the necessity of contributions to a profit-sharing trust

[5] The following are cited to give the reader an adequate source for solving nearly all imaginable problems which would arise in dealing with a pension or profit-sharing trust. Hess and Guterman, "Annuity Trusts and the Federal Income Tax," 55 HARV. L. REV. 329 (1942); Rice, "The Recent Pension Trust Regulations," 21 TAXES 486 (1943); Becker, "Pension Trusts Under the New Regulations," 21 TAXES 531 (1943); Simons, "Pension Trusts—Questions and Answers," 21 TAXES 555 (1943); Freyburger, "Pension Plans—The Philosophy of Section 165(a)," 22 TAXES 60 (1944); Spindell, "Current Problems Regarding Pension and Profit-Sharing Trusts," 23 TAXES 161 (1945); Gutkin, "A Critical Study of Bureau Procedure in Handling Examination of Employees' Trusts," 3 INST. FED. TAX. 80 (1945); Harrill and Miller, "Tax Implications of Termination of Pension Plans," 27 TAXES 191 (1949); Magill, "The *Lincoln Electric Co.* Decision in the Light of *Roberts Filter Mfg. Co.*," 7 INST. FED. TAX. 80 (1949); Storms, "The Lincoln Electric Question: Must *Ordinary and Necessary* Business Expenses Be Also *Reasonable* in Amount?" 49 MICH. L. REV. 395 (1949); P-H 1952 FEDERAL TAX HANDBOOK, ¶3020; P-H, PENSION AND PROFIT SHARING SERVICE, ¶¶5000-6000 (1951); and note 57 HARV. L. REV. 247 (1944).

[6] See I.R.C., §§23(a), 23(p)(1); Treas. Reg. 111, §29.23(p)-1.

[7] The principal case indicates that the plaintiff made this contention, but apparently did not offer satisfactory proof thereof.

[8] See Commissioner v. Lincoln Electric Co., (6th Cir. 1949) 176 F. (2d) 815, commented on, 49 MICH. L. REV. 395 (1951), and 7 INST. FED. TAX. 80 (1949).

[9] Treas. Reg. 111, §29.23(p)-1. See also P-H, PENSION AND PROFIT-SHARING SERVICE, ¶5015 (1951).

[10] Jos. N. Neel Co., Memo. T.C. Dkt. #24927 (March 30, 1951), 1951 P-H TCM ¶51,098; Charles E. Smith & Sons Co. v. Commissioner, Memo. T.C. Dkt. #9461, #9462 (May 12, 1947), 1947 P-H TCM ¶47,128.

must be proven, and the burden is on the taxpayer.[11] This may be prompted by the fact that deductions for contributions to profit-sharing trusts are allowed to a far greater extent than are contributions to pension trusts,[12] and thus the Treasury feels that they should be proven deductible all the way, even though they may not exceed, or even equal, the statutory maximum. This would lead to the conclusion that even contributions made in strict compliance with an approved plan would not be per se "ordinary and necessary" unless the Treasury Department has examined total compensation figures and passed on them, and it would seem that such an examination would have to be repeated each year. It is submitted that the interests of administrative expediency would be best served by admitting that all contributions to such plans which are within the statutory limits are "ordinary and necessary" and that the section 23(a) test of reasonableness be employed in all cases where there is some question as to the propriety of such contributions.[13] However, it is submitted that the conclusion of the court in the principal case is still correct, for variations from approved plans should not be sanctioned even though such variations are within the statutory allowances. It is clear that an employer can reserve the right to alter or terminate the plan of trust.[14] But it is also clear that the legislative and administrative provisions describing allowable deductions for contributions call for definite and predetermined formulas for profit-sharing, as well as predetermined contribution formulas.[15] Now if the terms for contribution are actually ambiguous, then the extent of permissible deduction is a question of the settlor's intent as to yearly contribution, such intent being determined as of the time of the trust's creation.[16] But once the formula for contribution has been

[11] Botany Worsted Mills v. United States, 278 U.S. 282, 49 S.Ct. 129 (1929).

[12] Note also that because of difficulty of differentiating between profit-sharing trusts with pension features and straight pension plans, and because of temptation to take the largest possible deduction, the Code provides that a profit-sharing trust does not include any trust designed to provide benefits on retirement and covering a period of years if, under the plan, the amounts to be contributed by employer can be determined actuarially. See I.R.C., §23(p)(1)(C), Treas. Reg. 111, §29.23(P)-10.

[13] It should be noted that there has been a great deal of speculation that the "ordinary and necessary" and the "reasonableness" tests are one and the same. For a presentation of the opposing arguments concerning this proposition see 49 MICH. L. REV. 395 at 404 (1951). Clearly the distinction should not be based on terminology alone, but there is definite authority for saying that the two tests, though peas from the same pod, are not the same. See Commissioner v. Lincoln Electric Co., supra note 8.

[14] There are a number of dangers inherent in alteration and termination. See Harrill and Miller, "Tax Implications of Termination of Pension Plans," 27 TAXES 191 (1949).

[15] See Treas. Reg. 111, §29.165-1, where it is indicated that the term "plan" means a permanent program, as distinguished from one allowing flexibility.

[16] See Wooster Rubber Co. v. Commissioner, (6th Cir. 1951) 189 F. (2d) 878. The terms of the approved plan in this case were ambiguous. The court held that the intent of the officers of the corporation at the time of the creation of the trust should be allowed to govern, and allowed such intent to be proven by the statements of the officers themselves. Under this theory it might have been possible for the plaintiff in the principal case to have shown that the intention was to contribute all that was statutorily possible each year. This possibility seems improbable because of the unequivocal nature of the words used in the contribution formula.

determined, it must be adhered to strictly, alterations being accomplished only by prescribed procedures.[17] The formula in the plan in the principal case seems to be unequivocal, and thus the plaintiff's attempted variation therefrom should not be allowed to increase the amount of his deductions. The adoption of any other policy would permit a taxpayer who keeps his books on an accrual basis to divert profits retroactively into a trust far in excess of the amount actually contracted for at the beginning of the year. Of course tax minimizing through the use of the pension or profit-sharing trust is not at all improper, but adjustments arrived at after the end of the year, varying from the approved plan, are surely not those which Congress intended to be allowable deductions.

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[17] See note 10 supra. This can also be inferred from Wooster Rubber Co. v. Commissioner, note 16 supra, where the court assumed that variations from an approved plan would not be permitted, but reversed the Tax Court on other grounds.