TRANSFER OF PENSION PLAN CARRYOVERS

Follow this and additional works at: http://digitalcommons.law.yale.edu/ylj

Recommended Citation
TRANSFER OF PENSION PLAN CARRYOVERS, 60 Yale L.J. (1951).
Available at: http://digitalcommons.law.yale.edu/ylj/vol60/iss3/7

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in Yale Law Journal by an authorized editor of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.
This argument presumes that a transferred action is the same as an action brought originally in the convenient forum. But an action transferred to a convenient federal court is not new; it is the continuation of an action which began elsewhere, in the forum plaintiff chose originally. Either a state or federal court in that forum would apply local law if it tried the case. But where that forum has no forum non conveniens doctrine, the identity between state and federal courts—the basis of Erie—would be destroyed if the convenient federal court were able to apply the law of its own state.\(^6\)

Since forum non conveniens has been recognized in relatively few states, the Headrick court's result will be reached in most cases. But it should not be in all. Adherence to the principles of Erie requires that federal courts consult state law in deciding whether the law of the original or convenient forum applies to transferred actions.

---

Transfer of Pension Plan Carryovers*  

Pension plans ¹ usually include credits to employees for services rendered...
before the plan was initiated. And both employees and employer benefit if the employer immediately deposits enough money in the pension trust fund to pay off this past service cost. Employees are assured that when they retire adequate reserves will be available to cover their past services. And the employer may gain from immediate funding because interest earned by the deposits is not taxable to the trust.

However, tax treatment of the funded past service cost poses a difficult problem when the employer sells or merges his business. The Internal Revenue Code allows deduction of the funding cost as a business expense.

2. About 75% of the pension plans which provide for future service benefits also include compensation for past services. O'NEILL, op. cit. supra note 1, at 277, 284. The object of the pension is to enable the employee to retire at a certain age. Unless the pension plan includes credits to employees for past services, older employees will have little time to accumulate sufficient credit in the pension trust to provide an adequate retirement income. Because of this, they may also be less likely to seek or accept retirement.

The efficacy of past service credits has already been recognized by the courts. As one court pointed out, "[p]roviding additional retirement allowances, by reference to services rendered before the establishment of the retirement allowance plan (sometimes called 'past services') is a reasonable and proper and customary provision to accomplish the systematic retirement of such employees. . . . [I]t removes superannuated employees, reduces payroll, improves the morale and efficiency of the younger employees remaining in the employ, attracts better employees, and benefits the relations between the corporation and the public. . . ." Acker v. McDonald, N.Y.Co. Sup. Ct., entered April 26, 1940 (not officially reported) quoted in P-H PENSION AND PROFIT SHARING SERV. 2164 (1948). See also Osborne v. United Gas Improvement Co., 354 Pa. 57, 63-4, 46 A.2d 208, 211 (1946); Meyers v. Cowdin, 47 N.Y.S. 2d 471, 477 (Sup. Ct. 1944).

3. Since employees are protected to the extent that contributions have already been made, they need not fear that future adverse business conditions will curtail the employer's contributions.

4. Under § 165 of the Internal Revenue Code, the income of a qualified trust is tax-free. The employer with available cash who funds the past service costs thus reduces his ultimate expense by the amount of the tax-free accrual to the trust. To qualify as tax-free, a trust forming part of a pension plan must be for the exclusive benefit of the employees or their beneficiaries and meet a number of other tests. Generally these tests require that the trust be irrevocable, that it benefit a specified percentage of employees, and that the plan be nondiscriminatory. INT. REV. CODE § 165; U.S.Treas. Reg. 111, § 29.165 (1943).

5. Reasonable contributions under a pension plan are deductible as a business expense from the employer's gross income if the plan meets the requirements of a tax-free employee's trust. INT. REV. CODE §§ 23(a), (p). U.S. Treas. Reg. 111, § 29.23 (p)-1-8 (1943). See note 4 supra.

If an employer's contribution to a plan is deductible from the employer's income, the contribution is not required to be included in the employee's income in the year the con-
But to restrain employers from deducting the whole cost in a high tax year, it permits deduction of only 10% of the total cost of funding past services in any one year. Past service contributions in excess of this maximum may be carried forward and deducted in succeeding years at the same 10% rate. Thus when an employer sells or merges his business before he has taken the full deductions permitted, the question arises whether his successor may use the undeducted balance.

A recent ruling of the Pension Trust Division of the Internal Revenue Bureau apparently extends to pension plan carryovers an anomalous distinction evolved in construing other tax deduction carryovers of the Code. PS 62 presents the case of the N Company which acquired the assets of the M Company through a statutory merger. At the time of the merger the

---

6. CLARK, op. cit. supra note 5, § 62; WINSLOW AND CLARK, op. cit. supra note 1, at 86. See also SEN. REP. No. 960, 70th Cong., 1st Sess. 21–2 (1928).
7. An employer may deduct "an amount equal to the normal cost of the plan . . . plus, if past service or other supplementary pension or annuity credits are provided by the plan, an amount not in excess of 10 per centum of the cost which would be required to completely fund or purchase such pension or annuity credits as of the date when they are included in the plan . . . except that in no case shall a deduction be allowed for any amount (other than normal cost) paid in after such pension or annuity credits are completely funded or purchased." INT. REV. CODE § 23 (p)(1)(A)(iii).
10. Carryovers came into the Internal Revenue Code with the Revenue Act of 1918. Before that, taxes were assessed on a strict annual accounting basis. The 1918 Act provided that for any taxable year beginning after Oct. 31, 1918, and ending before Jan. 1, 1920, a net loss in one year could be deducted from the net income of the preceding year. If the loss was in excess of the net income of the preceding year, the excess was deductible from the income of the next succeeding year. 40 STAT. 1057, c.18 (1919).
11. The M Company in 1947 paid $500,000 to fund completely past service credits. It deducted one-tenth, or $50,000, in each of the years 1947, 1948, and 1949, leaving a balance of $350,000. In 1949 the corporation was liquidated and pursuant to a statutory merger all assets and liabilities were taken over by the N Company, which also assumed and continued the pension plan.
M Company had deducted three-tenths of its funded past service cost. The question for decision was whether either company could deduct the balance. The Pension Trust Division ruled that the remaining seven-tenths of the funded past service costs was available as deductions to the N Company over the next seven years. It pointed out that the problem of the past service carryover was one to be resolved according to the distinction between New Colonial Ice Co. v. Helvering \textsuperscript{12} and Helvering v. Metropolitan Edison Co.\textsuperscript{13}

Neither of these cases involved pension plan carryovers. In the New Colonial case, a new corporation acquired its predecessor's assets subject to liabilities. In return it gave its own stock. The successor sought deduction of the net operating loss carryover of the predecessor. Stressing the resemblance of the transaction to a cash sale,\textsuperscript{14} the Court held that the successor was not the same taxpayer as its predecessor and hence not entitled to the deduction. In the Metropolitan Edison case, a parent company which had merged with an operating subsidiary sought to deduct unamortized bond discount and expense of the former subsidiary. The Court held that because of the merger the successor was the same taxpayer as the predecessor and could take the predecessor's deduction.\textsuperscript{15} Since in PS 62 the N Company acquired its business by statutory merger, it was permitted to deduct the cost of past service credits funded by its predecessor.\textsuperscript{16} But had the acquisition been characterized as a purchase and sale, the inference seems plain that the successor would not have been permitted the deduction.

Distinguishing between merger and sale in permitting transfer of deduc-

\textsuperscript{12} 292 U.S. 435 (1934).
\textsuperscript{13} 306 U.S. 522 (1939).
\textsuperscript{14} The Court pointed out that in this case, as in the case of a cash sale, there would be continuity of business between the predecessor and the successor. However, there would not be the continuity of ownership and tax liability which is "the matter of importance here." 292 U.S. 435, 439–41 (1934). Here "in law and in fact the two corporations were not identical but distinct. This was plainly implied in the transfer of the assets and business from one to the other. That transaction was voluntary and contractual, not by operation of law. Thereafter neither corporation had any control over the other; the old corporation had no interest in the assets or business, and the chance of gain and risk of loss were wholly with the new one." \textit{Id.} at 441.

\textsuperscript{15} "Inasmuch as the transfer of the franchises and assets is authorized by statute, it seems reasonably clear that the transferee is, as matter of law, liable for the obligation of the transferor. . . . "We are of opinion that a transfer without valuable consideration, with the intent that the transferor shall, as the statute provides, cease to exist, made in accordance with the statute, has all the elements of a merger and comes within the principal that the corporate personality of the transferor is drowned in that of the transferee. It results that the continuing corporation may deduct unamortized bond discount and expense in respect of the obligations of the transferring affiliate." 306 U.S. 522, 528–9 (1939).

\textsuperscript{16} After comparing the New Colonial case with the Metropolitan Edison case, the Division declared: "Accordingly, since the N Company acquired the assets of the M Company pursuant to a statutory merger which by operation of law effected a fusion of the assets and liabilities of the respective companies it is entitled to deductions in succeeding years, commencing in 1950, with respect to the balance of $350,000.00 to the same extent
tions makes little sense even in its original context. The distinction has been applied to unamortized bond discount \(^{17}\) and excess profits credit carryovers \(^{18}\) as well as to deductions for interest paid \(^{19}\) and taxes paid.\(^{20}\) It grew out of the language of the Code which limits deductions to the "taxpayer." \(^{21}\) Unless the transferee is the same taxpayer as the entity which fulfills the statutory requirements for the deduction, it cannot take the deduction. The courts have refused to consider a transferee corporation the same taxpayer as its predecessor where there is not continuity of tax liability "by operation of law." \(^{22}\) This continuity is found in the usual statutory

as the M Company would have been entitled had it continued in business." PS No. 62, 5-5-1950, P-H Pension and Profit Sharing Serv. ¶ 9561 (1950).


18. In Stanton Brewery Inc. v. Commissioner, 176 F.2d 573 (2nd Cir. 1949), a successor by merger was permitted to deduct the predecessor's carryover. The court was there construing a former excess profits provision of the Code. 54 Stat. 975 (1940) as amended, 26 U.S.C. § 710 (c)(3)(B) (1946). But the same rule will probably apply to the present carryover provision.

19. Where interest was paid on the indebtedness of a predecessor which accrued prior to a purchase of the assets subject to liabilities, it has been called a capital payment and disallowed. Rodney Inc. v. Commissioner, 145 F.2d 692 (2nd Cir. 1944). But if the predecessor was acquired by merger, the deduction has been permitted. Koppers Coal Co., 6 T.C. 1209, 1223 (1946).

20. Adrian & James Inc. v. Commissioner, 4 T.C. 708 (1945) (deduction permitted to the resulting company in a merger); Falk Corp. v. Commissioner, 60 F.2d 204 (7th Cir. 1932) (deduction denied to a transferee by purchase).

21. Those sections of the Code providing deductions for excess profits credit and interest paid use the term "taxpayer." INT. REV. CODE §§ 23(b), 432(c). A similar problem of who is the "taxpayer" has arisen under the sections providing deductions for unamortized bond discount and taxes paid. Id. § 23(c); U.S. Treas. Reg. 111, § 29.22(a)-17 (1943). However, in permitting credits for unused dividends paid, the Code uses the term "corporation." INT. REV. CODE §§ 26, 27. In Stanton Brewery Inc. v. Commissioner, 176 F.2d 573 (2nd Cir. 1949), Judge Clark pointed to this difference in statutory language as the explanation of why the dividends paid credit was held unavailable to transferees by merger in Jones v. Noble Drilling Co., 135 F.2d 721 (10th Cir. 1943), and Marion-Reserve Power Co. v. Commissioner, 1 T.C. 513 (1943). Id. at 576. But see Adrian & James Inc. v. Commissioner, 4 T.C. 708, 719 (1945).

22. American Gas and Electric Co. v. Commissioner, 85 F.2d 527,530 (2nd Cir. 1936). See also note 14 supra.
merger or consolidation. However, purchase of the assets of the corporation and contractual assumption of its liabilities is insufficient to meet the "same taxpayer" test.

There is no sound reason for differentiating between these various methods of asset transfer. Functionally they are equivalent. In a sale of assets and dissolution as well as in a merger there is one successor corporation left. It has the assets of the old corporation. In return it has given cash or stock. And though a corporation may use a sale rather than a merger in order to transfer its assets, the choice will be dictated by considerations which have no relation to deduction policy. It may be based on the language of state statutes or of corporate charters, as well as the availability of cash or the desire of shareholders to part with stock. Tax consequences should not hinge on these considerations.

In the pension plan context, the "same taxpayer" theory is not only inapposite, but it is likely to do positive harm. Under PS 62, where the employer sells his total business and dissolves, he can never realize on his unused deductions. As a result of his dissolution, he cannot take them himself. And since the purchaser cannot use them, the price to the seller will be proportionately less. Therefore an employer contemplating the possibility of a sale or merger and unsure of the method will attempt to protect himself against the denial of a carryover to his successor. If he sets up a pension plan, he may choose not to include past services at all. Or he may fund the costs over a long enough period to make the contributions deductible in the year made. In that event, if a sale or merger occurs, the older employees who are primarily interested in credit for past services may lose the unfunded portion. The successor may have no plan at all. Even if he does, he may not give credit for services rendered to the predecessor employer. For the social pressures to compensate another's older employees are not particularly strong. Besides, the cost of giving credit for such past services

24. See notes 17, 19, and 20 supra.
25. For a discussion of various statutory provisions, see 15 FLETCHER, op. cit. supra note 23, at 7055–9.
26. Neither the Internal Revenue Code nor the Treasury Regulations require the inclusion of past services. Some plans make no provision for them. See note 2 supra. Other plans are arranged so that the employer does not obligate himself to make such contributions. He merely advises his employees that it is his intention to do so, circumstances permitting. O'NEILL, op. cit. supra note 1, at 126–7.
27. If the employer funds the past service cost in ten or more equal installments, each installment will be deductible in the year contributed. INT. REV. CODE § 23 (p)(1)(A)(iii). See note 7 supra.
28. When an employer chooses to include benefits for services rendered to a predecessor, he can deduct his cost in funding these past service benefits. Special Ruling, issued Oct. 23, 1944. PENSION TRUST RULINGS ¶ 2621 (CCH 1945).
NOTES

is likely to be too great. Thus the net effect of PS 62 may well be to harm the employees for whose benefit the pension deduction is allowed. 29

Moreover, there need be no greater fear of tax avoidance in awarding a carryover to a purchaser than to a transferee by merger. Under either transfer method the successor who has acquired an impoverished enterprise primarily for its carryovers cannot benefit thereby. Under the Code, the Commissioner may disallow deductions of this sort. 39 Nor is there any problem of two claimants for the same deduction, for the seller has dissolved. And the employees for whose sake the deductions have been granted are protected no matter which method of transfer is used. In neither case can the successor divert the trust corpus or income to his own use. 31

Under the Code, an employer is persuaded to make a socially desirable expenditure by the assurance that his cost will be deductible. 32 But the rule advanced by PS 62 penalizes employers who have already funded past service credits. And it is likely to discourage lump sum funding of past service credits in the future. Consistency of tax administration is a desirable end. But the need for consistency would be better served by re-evaluating the "same taxpayer" theory itself than by extending it to the pension plan area.

29. See the statement of Randolph Paul, Special Tax Advisor to the Secretary of the Treasury: "The present treatment of pension trusts affords a tax subsidy to those trusts which meet the requirements set forth in the statute. This subsidy is at the expense of the general body of taxpayers. It was granted because of the desire to improve the welfare of employees by encouraging the establishment of pension trusts for their benefit." Hearings Before the House Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess. 2405 (1942). See also Drye, op. cit. supra note 1, at 2; Hearings Before the Joint Committee on Tax Evasion and Avoidance, 75th Cong., 1st Sess. 290 (1937) (statement of Charles T. Russel, Deputy Commissioner of Internal Revenue); id. at 306 (statement of Roswell Magill, Under-secretary of the Treasury).


31. "Under section 165 (a)(2) a trust is not exempt unless under the trust instrument it is impossible (in the taxable year and at any time thereafter prior to the satisfaction of all liabilities to employees or their beneficiaries covered by the trust) for any part of the trust corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of such employees or their beneficiaries." U.S. Treas. Reg. 111, § 29.165-2(a) (1943).

If a plan is terminated, the employer can only revest himself with such balance in the trust as is due to "erroneous actuarial computation." This would be the balance remaining after the satisfaction of all fixed and contingent liabilities to employees under the plan. Id., § 29.165-2 (b).

32. That tax considerations influence the use of pension plans seems clear. Eighty-five per cent of the pension plans in existence in 1949 were begun after 1942, the beginning of high corporate taxes. Wilson, supra note 1, at 341. Corporations claimed over one billion dollars as deductions under § 23(p) on income tax returns filed in 1948, a 25% increase over the previous year. See P-H PENSION AND PROFIT SHARING SERV. ¶ 34.2 (1950). It is expected that the pension movement will continue to gain impetus under the current tax laws. "If predictions in trust circles come true, from 5,000,000 to 6,000,000 workers in business and industry not now enrolled in pension plans will be covered within the next few years. . . ." N.Y. Times, Feb. 11, 1951, § 3, p.1, col. 4.