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to delineate the scope of and grounds for civil liability under rule 15c1-7.

CHARLES E. ELROD, JR.

Taxation—Charitable Deductions—Bequest for Benefit of Employees

The majority shareholder of a corporation made a bequest of forty per cent of his residuary estate to a testamentary trust to provide pension payments to the employees of the corporation. Employees employed prior to, or at the time of, decedent's death who retired after twenty-five years of service were to receive monthly pension payments of not more than 125 dollars.¹ Yearly trust income in excess of that needed for pension payments was to be paid over to an employees' trust fund created by the corporation in 1946 for pension purposes. Upon the death of the last surviving employee-beneficiary, the trustees of the testamentary trust were to terminate it by paying 2,000 dollars to each of three named hospitals and the remainder of the income and corpus to the employees' trust fund. If the employees' trust fund was not in existence, the income and corpus was to be divided equally among the three hospitals.

After the Commissioner of Internal Revenue refused to allow the decedent's bequest to the trust as a charitable deduction, the decedent's estate paid the asserted estate tax deficiency and sued in a federal district court for a refund. The district court,² relying on an earlier Third Circuit decision,³ held that the bequest was charitable and qualified for a deduction under section 812(d) of the 1939 Internal Revenue Code (the predecessor of section 2055 of the Internal Revenue Code of 1954). The court found that sufficient public benefit flowed from the trusts to make them charitable, the beneficiaries of the trusts were ascertainable, and the discretion vested in the trustees was limited to disbursements for charitable purposes. On appeal, in *Watson v. United States*⁴ a divided Third Circuit reversed and held that the testamentary trust was not charitable. The majority of the court found that the trust benefited the

¹ The exact amount was to be determined by subtracting from \$125 the amount of Social Security benefits and corporate pension payments received by an employee. Corporate officers and directors were not to receive pension payments.

² *Watson v. United States*, 63-2 U.S. Tax Cas. 90, 379 (D.N.J. 1963).

³ *Gimbel v. Comm'r*, 54 F.2d 780 (3d Cir. 1931).

⁴ 355 F.2d 269 (3d Cir. 1965).

corporation as well as the employees, represented compensation to the employees, and was an ordinary pension trust which Congress distinguished from charitable organizations by sections 401(a), 501(a) and 501(c)(3) of the Internal Revenue Code of 1954. The court prefaced its reasoning with the statement, "We are not here dealing with an impoverished class."⁵ The court also held that a New Jersey Superior Court's holding that the testamentary trust was charitable⁶ was not binding in a federal tax determination.

A concurring opinion underscored the majority's holding that local definitions of charity are not binding in federal tax determinations. A dissenting judge, taking an opposite view of the effect of local law, expressed the opinion that the finding of the New Jersey Superior Court was binding and precluded independent consideration of the issue in the tax case. Another dissenting judge would have affirmed on the reasoning and findings of the district court.

Prior to the *Watson* decision, it was generally believed that gifts and bequests for the benefit of employees could result in charitable deductions under the federal income and estate taxes. A long line of cases had held that gifts providing retirement or welfare benefits to employees were in the public interest and should be encouraged.⁷ The majority in *Watson* refused to follow these precedents and indicated that such gifts and bequests are no longer charitable in the Third Circuit.

In applying section 812(d) the *Watson* court divided on two points: the effect of local law and the characterization of employee pension trusts.

⁵ *Id.* at 271.

⁶ Passaic-Clifton Nat'l Bank & Trust Co., Super. Ct. Ch. Div. Essex County C458-55, April 22, 1957. The court held that both the testamentary and the employees' trusts were charitable and therefore not subject to the New Jersey Rule Against Perpetuities. In an unrelated action, *Watson v. Brower*, 24 N.J. 210, 131 A.2d 512 (1957), the New Jersey Supreme Court, in ruling on the use of the word "retire" in the testamentary trust, noted that the trust was intended to benefit the corporation as well as the employees.

⁷ *Harrison v. Barker Annuity Fund*, 90 F.2d 286 (7th Cir. 1937); *Gimbel v. Comm'r*, 54 F.2d 780 (3d Cir. 1931); *Eagan v. Comm'r*, 43 F.2d 881 (5th Cir. 1930); *Mutual Aid & Benefit Ass'n v. Comm'r*, 42 F.2d 619 (3d Cir. 1930); *Estate of Leonard O. Carlson*, 21 T.C. 291 (1953); *T.J. Moss Tie Co.*, 18 T.C. 188 (1952), *petition to review docketed and dismissed on motion of petitioner and consent of respondent*, 201 F.2d 512 (8th Cir. 1953); *Estate of Lillian D. Wald*, 13 P-H Tax Ct. Mem. 855 (1944); *Estate of Carolyn E. Gray*, 2 T.C. 97 (1943); *Proctor Patterson*, 34 B.T.A. 689 (1936); *John R. Sibley*, 16 B.T.A. 915 (1929).

I. EFFECT OF LOCAL LAW

The role of local law in federal tax litigation has been kept at a minimum in an endeavor to achieve nationwide uniformity in federal taxation. The Supreme Court set forth the guidelines in *Burnet v. Harmel*⁸ when it declared that the Internal Revenue Code should "be interpreted so as to give a uniform application to a nationwide scheme of taxation."⁹ Following this idea, the Court in *Lyeth v. Hoey*¹⁰ held that property that an heir received under a will compromise was acquired by "inheritance," as that term is used in the income tax, and was therefore exempt from the income tax despite the fact that under the local state law the heir acquired the property by a contract with the legatee named in the decedent's will. The Court said:

Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law. . . . There is no such expression or necessary implication in this instance. Whether what an heir receives from the estate of his ancestor through the compromise of his contest of his ancestor's will should be regarded as within the exemption from the federal tax should not be decided in one way in the case of an heir in Pennsylvania or Minnesota and in another way in the case of an heir in Massachusetts or New York, according to the differing views of the state courts. We think that it was the intention of Congress in establishing this exemption to provide a uniform rule.¹¹

Although the federal estate tax exempts gifts to charity, it does not define "charitable."¹² It would be possible to determine whether a bequest was charitable by recourse to the state law governing the bequest, but this would mean that a bequest by a decedent domiciled in one state might be charitable and deductible for purposes of the federal estate tax, while an identical bequest by a decedent domiciled in another state would not be charitable and deductible. In other words, this would lead to the lack of uniformity that the Supreme

⁸ 287 U.S. 103 (1932).

⁹ *Id.* at 110.

¹⁰ 305 U.S. 188 (1938).

¹¹ *Id.* at 194.

¹² LOWNDES & KRAMER, FEDERAL ESTATE AND GIFT TAXES 352 (2d ed. 1962); 4 MERTENS, LAW OF FEDERAL GIFT AND ESTATE TAXATION 345 (1959).

Court sought to avoid in *Lyeth v. Hoey*. The majority of the court in the *Watson* case may have acted properly in refusing to be bound by state decisions holding the trust charitable. The term "charitable" in a federal tax statute may like "inheritance" in the federal income tax be a term that should be defined by a uniform federal definition. It seems apparent, however, that if the federal courts are not going to be bound by the law of a particular state in defining the term "charitable," they should not eschew the common law entirely. There are basic common-law conceptions about what are charitable purposes that might well be used as the foundation for a uniform federal tax definition of charitable. If the majority in the *Watson* case derived its decisions from any such general principles, it failed to articulate clearly either the principles or the nexus between them and its conclusion.

II. EMPLOYEE TRUSTS

The *Watson* decision rests primarily upon a finding that Congress did not intend for employee pension trusts to be charitable organizations within the meaning of the Code. Apparently the court reasoned that Congress by expressly providing for the tax treatment of pension trusts in sections 401(a) and 501(a) excluded employees' pension trusts from charitable organizations under section 501(c)(3). This finding was based in part on Revenue Ruling 56-138,¹³ which the majority found to be on all fours with the facts in *Watson*. In that ruling a corporation sought to deduct as charitable contributions payments to a trust organized and operated by the corporation to provide pensions to retired employees and benefits to certain employees who were to be selected by an executive committee. The Commissioner ruled that trusts organized primarily for the purpose of paying pensions to retired employees were not organized exclusively for charitable purposes within the meaning of section 501(c)(3) and were, therefore, not entitled to an income tax exemption under section 501(a). Section 401(a), as well as Revenue Ruling 56-138, deals specifically with one type of pension trusts—pension trusts created and funded by a corporate employer. If such a trust meets the many requirements of section 401, it receives favorable tax treatment from other sections of the Code.¹⁴

¹³ 1956-1 CUM. BULL. 202.

¹⁴ Generally, §§ 402 and 403 provide that amounts contributed to quali-

Such trusts are distinguishable from charitable organizations. Section 401 is in no way concerned with pension trusts created and funded by nonemployers. The section has no relevancy to a bequest in trust for the retirement of employees. It is highly improbable that Congress intended the section to have any effect whatever on the tax status of a bequest similar to the one in *Watson*. Whether or not a gift to an employees' trust is charitable would appear to depend upon the circumstances surrounding the gift. Corporate contributions to an employees' trust created by the corporation for the primary benefit of its officer-stockholders might well be viewed differently than a bequest by a disinterested philanthropist to a trust to provide modest retirement benefits for the impecunious employees of a depressed industry.

The *Watson* decision was also grounded on findings that the beneficiaries of the trust were not impoverished and the bequest was not charitably motivated. It is doubtful that the Third Circuit intended to limit the recipients of charitable giving to the impoverished. It is well established that those of modest means as well as paupers are proper objects of charitable trusts.¹⁵ Indeed, a means test is not a necessary ingredient of a charitable trust. Relief of poverty is but one of several charitable purposes recognized by the law.¹⁶

Apparently the court in *Watson* felt that the fact that the decedent had been the majority shareholder of the corporation established a lasting employer-employee relationship between him and the employees that survived his death. On the basis of this relationship the majority found that the bequest was intended to and did benefit both the employees and the corporation. In attributing selfish designs to the decedent, the majority overturned the finding of the district court that he was charitably motivated.

fied pension plans by employers will not be taxed to the employees until distributed pursuant to the plan. Employers are allowed, within prescribed limits, an immediate deduction from gross income for contributions to qualified pension plans under § 404.

¹⁵ *Bowditch v. Attorney Gen.*, 241 Mass. 168, 134 N.E. 796 (1922); *Gibson v. Frye Institute*, 137 Tenn. 452, 193 S.W. 1059 (1916); *New England Sanitarium v. Inhabitants of Stoneham*, 205 Mass. 335, 91 N.E. 385 (1910); *Godfrey v. Hutchins*, 28 R.I. 517, 68 Atl. 317 (1907); RESTATEMENT (SECOND), TRUSTS § 374, comment *g* (1959); BOGERT, TRUSTS 145 (4th ed. 1963); 4 SCOTT, TRUSTS § 374.11 (2d ed. 1956).

¹⁶ See generally RESTATEMENT (SECOND), TRUSTS §§ 368-74 (1959); BOGERT, TRUSTS §§ 57-64 (4th ed. 1963); 4 SCOTT, TRUSTS §§ 368-74 (2d ed. 1956).

Prior cases consistently had held that organizations dedicated to the well-being of employees could be charitable for tax purposes.¹⁷ Gifts and bequests for the retirement or welfare of employees were deemed to be in the public interest and were to be encouraged.¹⁸ The courts did not deny charitable deductions because of selfish motives of the donor, the lack of need of some of the benefited employees, or the promised benefits inducing employees to work longer and harder.¹⁹

Scott, Bogert and the *Restatement of Trusts* indicate that trusts for the aid and relief of employees can be charitable.²⁰ Bogert states that employee pension trusts can be charitable,²¹ but comment 375(g) of the *Restatement*, without citing authority, flatly asserts that employee pension trusts are not charitable.

Although the weight of authority is stacked against the *Watson* decision, much of the authority is a product of the depression years. Perhaps the tax status of employee pension trusts should be re-examined in light of existing social and economic conditions. Certainly with the emergence of Social Security, corporate pension plans, and other forms of old age assistance such as Medicare, the reasons for bestowing tax benefits to encourage private assistance to the elderly are not as obvious as they were thirty years ago. The court would have been on firmer legal footing if it had based its decision on the noncharitable aspects of the employees' trust fund. This trust was to receive unascertainable yearly pour-overs of income from the testamentary trust and the remainder of the corpus and income of the trust on its termination. The employees' trust fund was amendable by collective bargaining, made its trustees subject to the instructions of the board of directors of the corporation and was funded by the corporation. Indeed, it would appear to be exactly the type of trust that section 401(a) would distinguish from charitable organizations. If this trust was not organized for charitable purposes,²² an unascertainable amount of the bequest to the

¹⁷ See note 7 *supra*.

¹⁸ See 1 PAUL, FEDERAL ESTATE AND GIFT TAXATION 645-47, 650 (1942).

¹⁹ *Harrison v. Barker Annuity Fund*, 90 F.2d 286 (7th Cir. 1937).

²⁰ RESTATEMENT (SECOND), TRUSTS § 375, comment *g* (1957); BOGERT, TRUSTS 166 (4th ed. 1963); 4 SCOTT, TRUSTS 2711 (2d ed. 1956).

²¹ BOGERT, TRUSTS § 61, at 166 (4th ed. 1963).

²² The district court found that the employees' trust fund was charitable, *Watson v. United States*, 63-2 U.S. Tax Cas. 90,379 (D.N.J. 1963), relying in part on *Passaic-Clifton Nat'l Bank & Trust Co.*, Super. Ct. Ch. Div. Essex County C458-55, April 22, 1957, which held that the employees' trust

testamentary trust was not to be used exclusively for charitable purposes, and clearly the deduction should not be allowed.

It is doubtful that the *Watson* case stands for the proposition that a gift to a trust to provide retirement benefits for employees cannot be charitable for federal tax purposes. The deductibility of such gifts appears to depend upon the circumstances surrounding the gift, such as the persons benefited by the trust, the nature and extent of their benefits, the relation between the donor and the beneficiaries of the trust and any possible advantages accruing to the donor from the gift to the trust.

WILLIAM S. LOWNDES

Torts—Parent-Child Immunity

In *First Union Nat'l Bank v. Hackney*¹ the North Carolina Supreme Court held that a parent's common-law immunity to tort claims brought by his unemancipated minor children² does not apply to prevent recovery where a wrongful death action is brought by the administrator of one parent against the estate of the other parent, for the benefit of the children.

In *Hackney* the parents of four minor children were killed when the family car ran off a highway and hit a tree. The administrator of the mother's estate brought a wrongful death action against the estate of the father based on his alleged negligence in losing control of the vehicle. The defendant asserted (1) that the children were the real parties in interest *as plaintiffs* since any recovery in the action would go to them as sole distributees of their mother;

fund was charitable for purposes of the New Jersey Rule Against Perpetuities.

¹ 266 N.C. 17, 145 S.E.2d 352 (1965).

² Parent-child immunity to negligence claims of each other was an innovation of American courts. The first precedent for the rule was *Hewlett v. George*, 68 Miss. 703, 9 So. 885 (1891), where the court reasoned that:

The peace of society, and of the families composing society, and a sound public policy, designed to subserve the repose of families and the best interests of society, forbid to the minor child a right to appear in court in the assertion of a claim to civil redress for personal injuries suffered at the hands of the parent.

Id. at 711, 9 So. at 887.

"Parental authority" and the "security of the home" were two of the policy reasons which convinced a majority of the North Carolina court to adopt the parent-child immunity rule in *Small v. Morrison*, 185 N.C. 577, 118 S.E. 12 (1923).