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Notes

Investment of Pension and Profit-Sharing Trust Funds in the Employer's Business Under the Internal Revenue Code of 1954

The Internal Revenue Code does not provide clear directions for the operation of a qualified employees' trust. As a result, uncertainty surrounds the tax status of trust investments in the employer's business. The author of this Note analyzes the restrictions imposed upon such investments and demonstrates their effects upon four basic transactions between the employer and the employees' trust. He concludes that the Code allows extensive investments in the employer's business and that Congress should provide specific guides for such investments in order to protect the employees' interests.

INTRODUCTION

During the past decade the value of private pension and profit-sharing funds has increased almost 400 per cent.[1] While many factors have contributed to this increase,[2] the most significant have been the tax allowances granted in connection with *qualified*[3] trusts. These allowances have enabled qualified pension and

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1. SEC, *Survey of Pension Fund Investments*, Statistical Series Release No. 1680, May 31, 1960. See S. REP. No. 1734, 84th Cong., 2d Sess. 13 (1956); TILOVE, PENSION FUNDS AND ECONOMIC FREEDOM 9–19 (1959); Note, 70 HARV. L. REV. 490 (1957).

2. Some of the contributing factors were: (1) § 9(a) of the National Labor Relations Act which required employers to bargain on the establishment of pension plans, Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948); (2) the "wage freeze" imposed during World War II, 56 Stat. 765, 768 (1942), and the Korean conflict, 64 Stat. 803 (1950), which excepted "fringe benefits" because they were non-inflationary; and (3) an extended period of prosperity combined with high corporate tax rates which made deductible expenditures desirable. See generally, Isaacson, *Employee Welfare and Pension Plans: Regulation and Protection of Employee Rights*, 59 COLUM. L. REV. 96, 98 (1959); Note, 58 COLUM. L. REV. 78, 79–80 (1958).

3. In order for a trust forming part of a pension, profit-sharing, or

profit-sharing plans to enjoy a comparatively low net cost.[4] The employer's contribution to the employees' trust is deductible from gross earnings;[5] the employees' tax liability caused by the employer's contribution is deferred until benefits are received;[6] and

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stock bonus plan to constitute a qualified trust under section 401(a), the following tests must be met:

(i) It must be created or organized in the United States, as defined in section 7701(a)(9), and it must be maintained at all times as a domestic trust in the United States;

(ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries . . . ;

(iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with the plan;

(iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries . . . ;

(v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify, under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees . . . ; and

(vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees . . . .

Treas. Reg. § 1.401-1(a)(3) (1958).

For a discussion of *non-qualified* deferred compensation arrangements see Neal, *Deferred Compensation Plans: Qualifying For Non-Qualified Treatment*, in SELECTED PROBLEMS IN THE LAW OF CORPORATE PRACTICE 374 (Roady & Andersen ed. 1960).

4. S. REP. No. 1734, 84th Cong., 2d Sess. 13 (1956). See ROBBINS, IMPACT OF TAXES ON INDUSTRIAL PENSION PLANS 46–62 (Industrial Relations MONOGRAPH No. 14, 1949); Wilson, *Employee Pension Plans*, 15 LAW & CONTEMP. PROB. 340 (1950).

As one author commented,

> the Federal Government is presently subsidizing private pension programs by allowing deduction of payments to pension plans as expenses, by exempting income from pension funds from taxation, and by favorable tax treatment of employees covered by the plan.

Id. at 351.

5. INT. REV. CODE OF 1954, § 404 [hereinafter cited as I.R.C.]. In order to qualify as a deduction under § 404, however, the contribution must also meet the requirements of a deductible expense under § 162 or § 212. I.R.C. § 404(a). Thus, the contribution must be an ordinary and necessary expense of the employer in carrying on his trade or business, or it must be for the production of income. Furthermore, the contribution must be compensation for personal services actually rendered. I.R.C. §§ 162, 212; Treas. Reg. § 1.404(a)-1(b) (1956).

6. I.R.C. § 402(a); *cf.* I.R.C. § 72(d). The employee or his beneficiary must report as taxable income or gain, benefits "distributed or made available" to him. Benefits "made available" include trust funds used to purchase life insurance for the employees, Raymond J. Moore, 45 B.T.A. 1073 (1941), or to provide a current economic advantage. Alexander, *Rights of Employees and Their Widows and Heirs, Under Qualified Section*

the income earned by the trust is tax exempt.[7]

Today, private corporate pension and profit-sharing funds have accumulated assets in excess of $44 billion.[8] More than half of this amount is held by noninsured plans and is available for investment in the employer's business.[9] However, few trusts have used their funds to increase the employer's working capital.[10] Several factors have accounted for the absence of trust investment in the employers' businesses. In the first place, the pension and profit-sharing field is "one of the most complicated and involved parts of the law."[11] Consequently, fund trustees are uncertain what investments in employers' businesses are permitted. Also, the trustees are usually officers of the employer-company and thus reluctant to engage in transactions that may open them to a charge

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401(a) Plans: Income Tax Consequences, N.Y.U. 16TH INST. ON FED. TAX 37, 38–39 (1958).

7. I.R.C. §§ 401, 501(a).

8. SEC, *Survey of Pension Fund Investments,* Statistical Series Release No. 1680, May 31, 1960.

9. *Ibid.* In contrast to noninsured funds, insured pension funds are used for the purchase of insurance either by the employer or by an employees' trust established under the plan. Therefore, insured pension funds are not available for other investments. Otherwise, with few exceptions, the plans are trust administered and the funds are available for investment by the trustees. For a thorough description of the various types of plans see N.Y. STATE INS. DEP'T, PRIVATE EMPLOYEE BENEFIT PLANS—A PUBLIC TRUST 71–88 (1956); Note, 58 COLUM. L. REV. 78, 81–90 (1958).

10. For example, in a survey of 1,024 pension trusts with book value assets of $4.9 billion, only 109 trusts indicated any investments in the employer corporation. These investments in the employer's business amounted to $315 million and were rated as follows: 95.05% were of investment grade, .59% were sub-standard, and 4.36% were not rated. Almost 90% of the investments were in the employer's bonds; the remainder were distributed among stocks, real estate with leasebacks, and promissory notes. N.Y. STATE BANKING DEP'T, PENSION AND OTHER EMPLOYEE WELFARE FUNDS at xiv, xvi, 28–29 (1955).

The Securities and Exchange Commission has reported that at the end of 1954 company stock investments represented 2.7% of pension fund assets.

> Of this amount . . . 85 per cent was held by trade companies, almost all of which was accounted for by the holdings of the Savings and Profit Sharing Pension Fund of Sears, Roebuck & Co. employees. If the Sears fund is excluded, then the percentage of total assets invested in own company stock drops to one-half of one percent.

SEC, SURVEY OF CORPORATE PENSION FUNDS, 1951–1954, at 13 (1956). See Business Week, Jan. 31, 1959, pp. 88, 98–99.

11. Durkin, *Non-Qualified Deferred Compensation Plans,* 29 U. CINC. L. REV. 68, 69 (1960).

As Mr. Goodman, Chief of the Internal Revenue Service Pension Trust Service, admitted, "the tax problems which arise in the investment of an exempt employees' trust are many and varied." Address by Isidore Goodman, Western Pension Conference (Los Angeles Chapter), Nov. 17, 1960, in 2 CCH PENSION PLAN RUL. ¶ 11106. Thus, the prudent trustee will request an advance ruling on investments in the employer's business. See 1 RABKIN & JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 15.01, at 1504 (1954).

of self-dealing.[12] Finally, as guardians of the employees' interests, the trustees are concerned with the fact that such investment will increase the employees' exposure to the hazards of the business.[13]

The purpose of this Note is to outline four types of investments in the employer's business that are available to a qualified trust. The Note will first discuss the restrictions imposed on trust investments in the employer's business and then consider the effect of these restrictions upon four basic transactions between the employer and the employees' trust.

I. RESTRICTIONS ON EMPLOYEES' TRUST INVESTMENTS

Although the initial qualification of a pension or profit-sharing trust is governed by explicit provisions,[14] the 1954 Internal Revenue Code does not provide clear directions concerning the trust's operation.[15] There is a continuation of the 1939 Code policy of not specifically limiting the investments available to qualified employees' trusts.[16] However, the fact of qualification does not relieve the trustee of his duty to comply with the provisions of the

12. Six examples of "self-dealing" investments are described in N.Y. STATE INS. DEP'T, *op. cit. supra* note 9, at 128, 129. Compare AFL-CIO Policy on Health, Welfare Funds, 37 LRRM 77, 80 (1955).

13. As the vice chairman of the Board of Governors of the Federal Reserve System testified before Senator Paul Douglas' welfare and pension plan investigation subcommittee:

> Senator Douglas. But as to separate pension plans, do you think it is wise general practice to have the funds invested in securities of the same company in which the men have jobs?
>
> Mr. Balderston. In general I do not. First of all, it violates the principle of diversification of investments, and secondly, it places employee funds that they should be able to rely upon in "rainy seasons" in the same company on which they depend for their jobs and livelihoods.

Hearings Before the Subcommittee on Welfare and Pension Funds of the Senate Committee on Labor and Public Welfare, 84th Cong., 1st Sess., pt. 3, at 893 (1955) [hereinafter cited as *1955 Hearings*]. It is not surprising that the "typical insured [*sic*] pension plan, for example, is invested entirely in fixed-dollar securities—bonds and preferred stocks—which guarantee delivery of the proper dollars at maturity—but not the purchasing power of those dollars . . . ." Kearns, *Protecting Qualified Plans with Mutual Funds,* 37 TAXES 1023, 1024 (1959). See generally, Buek, *"Qualified" Trustee Performance,* 99 TRUSTS & ESTATES 194, 196 (1960); Lackman, *Investment Relations With Company,* 96 TRUSTS & ESTATES 258–59 (1957).

This problem is not peculiar to the United States. Canada, for example, discourages pension fund investments in the employer's business by summary denial of the employer's tax deductions for contributions to such plans. S. REP. No. 1734, 84th Cong., 2d Sess. 52 n.19 (1956).

14. I.R.C. § 401(a). See note 3 *supra.*

15. "No specific limitations are provided in section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under section 401(a)." Treas. Reg. § 1.401–1(b)(5)(i) (1958).

16. Treas. Reg. 111, § 29.165–1(a) (1943).

trust instrument and applicable local law.[17] He is generally restricted to those investments which would be considered proper by the "prudent investor." Furthermore, the Commissioner has ruled that the trustee's investments must insure that the fund maintains sufficient liquidity to fulfill the trust's commitments under the pension or profit-sharing plan.[18]

The "prudence" of a particular investment can be determined only with reference to a specific pension or profit-sharing plan. Questions of whether proper diversification and balance of investments have been achieved cannot be answered in the abstract. The Code does, however, set some outer limits within which all trust investment must remain if the trust is to maintain a fully nontaxable status.[19] First, the trust must be operated for

17. Treas. Reg. § 1.401-1(b)(5)(i) (1958); P.S. No. 49, June 16, 1945, in CCH 1945 STAND. FED. TAX REP. ¶ 6250. While the extent to which local trust law applies to employees' trusts is uncertain, it is clear that local law controls when the trust indenture is silent as to permissible investments. Treas. Reg. § 1.401-1(b)(5)(i) (1958); N.Y. STATE INS. DEP'T, *op. cit. supra* note 9, at 114; Note, 58 COLUM. L. REV. 78, 92-95 (1958). See 3 SCOTT, TRUSTS § 227.14 (2d ed. 1956); Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 135. However, the trust indenture's grant of broad investment powers to the trustee does not alter his status as a fiduciary subject to the rules of conduct required of trustees. See 3 SCOTT, *op. cit. supra*, at §§ 227.1, 227.14. For example, if the investment is unsound, although authorized by the trust instrument, the trustee is surchargeable for losses to the trust's beneficiaries.

18. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 135. See Scully, *Changing Concepts of Trust Investments: Diversification of Investments*, 97 TRUSTS & ESTATES 912 (1958); Ziskind, *The Law of Employee Benefit Plans*, 1955 WASH. U.L.Q. 112, 122-25.

In the case of an investment in the stock of a "close corporation," 1 O'NEAL, CLOSE CORPORATIONS § 1.02 (1958), the trust's major problem is the fact that the stock is not marketable and therefore the investment is not liquid, see *id.* § 1.07 at 15-16. However, the trustee's ability to closely supervise the investment would seem to be an adequate substitute for marketability. Thus, in order to insure that the trustee retains his ability to closely supervise the investment, the purchase agreement should provide for a veto power, "control of distribution," or a buy-out clause. See generally *id.* §§ 4, 5; 2 *id.* § 7.

19. These tax rules are not designed to guarantee the actuarial soundness of the trust; instead, they are designed to limit the amount that can be deducted for tax purposes and to protect the employees' interests. They do, however, incidentally establish minimum standards for the operation of the trust. See *1955 Hearings* at 838, 847.

While the tax rules were created for income tax purposes, violation of them can victimize parties that should be protected, the employee-beneficiaries. For example, if the trustee intentionally misuses trust funds, the tax consequences may include an assessment against the trust. The assessment is imposed because the loss of the trust's tax exemption is retroactive to the time of the infraction. Furthermore, the employees are denied tax deferment. See note 35 *infra*. See also S. REP. No. 1440, 85th Cong., 2d Sess. 15-16 (1958). However, the consequence of a tax rule violation has, in some cases, so thwarted the rules' purposes that the courts have mitigated their effect. For example, in Time Oil Co. v. Commissioner, 258 F.2d 237, 239 (9th Cir. 1958), the employer's variations from the approved plan nei-

the exclusive benefit of the employees or their beneficiaries.[20] Second, the trust must not engage in any "prohibited transactions."[21] Third, the trust must not earn "unrelated business taxable income."[22] Depending upon which of these rules is violated, the trust's status may be affected in different ways with differing tax consequences to the employer, the employees, and the trust.

A. EXCLUSIVE BENEFIT RULE

Section 401(a) provides that an employees' trust which is part of a plan "for the *exclusive benefit*" of the employees or their beneficiaries is a qualified trust "if under the trust instrument it is impossible . . . for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit" of the employees.[23] While it is arguable that the literal language of the Code applies the exclusive benefit rule only to the *establishment* of the trust,[24] the "exclusive benefit" requirement has been applied to the trust's *operation*.[25] Hence, if the trust is to retain its qualified status the fund must be administered for the exclusive benefit of the employees.

While the requirement that the trust be administered for the employees' exclusive benefit applies to the trust's total investment plan,[26] the major interpretive problem arises in regard to the individual transactions entered into by the trust. The Commissioner has created four coordinate and conjunctive tests by which to determine compliance with the exclusive benefit rule:

ther benefited him nor injured the employees. Since a loss of the trust's tax exemption would have injured the employees, the trust was permitted to retain its qualified and exempt status.

20. I.R.C. § 401(a).

21. I.R.C. § 503(c).

22. I.R.C. § 511.

23. I.R.C. § 401(a)(2). (Emphasis added.)

24. Section 401(a) appears to cover only the "requirements for qualification" of a plan. With one exception the subsections under § 401(a) are technical requirements governing the trust's qualification. Subsection (2) prohibits the *use* or *diversion* of trust funds for purposes other than for the exclusive benefit of the employees. However, this subsection is limited by the clause that such "use or diversion" must be made impossible by the trust instrument. I.R.C. § 401(a)(2). Therefore, the literal language of § 401 (a) would appear to cover only the trust's initial qualification.

25. Treas. Reg. § 1.401-1 (b)(3) (1958) ("The law is concerned not only with the form of a plan but also with its effect in operation."). See H.R. REP. No. 2333, 77th Cong., 1st Sess. 103 (1942); Tavannes Watch Co. v. Commissioner, 176 F.2d 211, 216 (2d Cir. 1949); Bomar, *Requirements for Qualification of Plans (Compensation Problems: Pension and Profit-Sharing)*, N.Y.U. 13TH INST. ON FED. TAX 395, 402 (1955).

Disqualification of the plan for violation of the exclusive benefit rule results in an automatic and immediate loss of the trust's tax exemption at the time of the violation. I.R.C. § 501(a). See H. S. D. Co. v. Kavanagh, 191 F.2d 831, 843-46 (6th Cir. 1951).

26. See text accompanying notes 17-19 *supra*.

> the cost must not exceed fair market value at the time of purchase, a fair return commensurate with the prevailing rate must be provided, sufficient liquidity is to be maintained so as to permit distributions in accordance with the terms of the plan, and the safeguards that a prudent investor would look to are to exist.[27]

In order to comply with these tests, every transaction entered into by the trust must meet the standards of an "arms-length" transaction.[28] Thus, if the trust purchases property the purchase price must not exceed the property's fair market value, and the purchase must not result in an impairment of the trust fund's liquidity; if the trust sells property the sale price must not be less than the property's fair market value; if the trust leases property it must receive rent equivalent to that received by lessors of similar property; or, if the trust loans money it must receive the prevailing rate of interest, and the loan must be a reasonably secure investment. In a transaction between unrelated parties, the competing interests of the trust and the third party would normally insure that the transaction is at arms-length. On the other hand, if the trust deals with the employer (or other related party), compliance with the standard of a fair market price or adequate return standard should insure that a constructive arms-length transaction has taken place.[29]

Although the transaction must be for the employees' exclusive benefit, this rule does not prohibit a transaction in which a party other than the trust's beneficiaries receives a benefit. In fact, an arms-length transaction assumes that the transaction is beneficial to both parties. As a result, the Commissioner has ruled that the trust will retain its qualified status even though the transaction confers incidental benefits upon someone other than the employees or their beneficiaries.[30] However, this ruling does not limit the original requirement that from the trust's view the transaction must be for the employees' exclusive benefit. Hence, the exclusive benefit rule is violated only if the transaction is so weighted that it objectively appears that the *primary purpose* of the transaction is to benefit someone other than the trust's beneficiaries. For example, if the trust were to borrow funds to invest in the employer's business, the trust would not necessarily have violated the exclusive benefit rule.[31] The trust will be disqualified in this situa-

27. Rev. Rul. 57–163, 1957–1 CUM. BULL. 128, 135.
28. For applications of what constitutes an arms-length transaction under other Code sections see, *e.g.*, Cooper Agency, 33 T.C. 709 (1960); Virginia Metal Prod., 33 T.C. 788 (1960).
29. This assumes that "sufficient liquidity is . . . maintained and the safeguards that a prudent investor would look to . . . [do] exist." Rev. Rul. 57–163, 1957–1 CUM. BULL. 128, 135.
30. *Ibid.*
31. Rev. Rul. 46, 1953–1 CUM. BULL. 287, 288.

tion only where the primary purpose of the transaction is to benefit the employer—as where the trust borrows funds in order to purchase company debentures at a time when the employer is unable to obtain funds from other sources.[32]

B. PROHIBITED TRANSACTIONS RULE

The prohibited transactions rule was first applied to employees' trusts by section 503(c) of the 1954 Code.[33] Six types of transactions are prohibited. If the employees' trust engages in any of these transactions with the employer (or other related parties)[34] the trust will lose its exempt status.[35] The purpose of the section was to insure that all dealings between an employer and his tax-exempt trust meet the standards of an "arms-length transaction."[36]

The transactions between the trust and the employer which are prohibited include: (1) a loan of trust funds without the receipt of *adequate security* and a *reasonable rate of interest*, (2) payment of any compensation beyond a reasonable amount for personal services actually rendered, (3) making trust services available on a preferential basis, (4) a substantial purchase of property for more than adequate consideration, (5) a sale of any substantial part of the trust's assets for less than an adequate consideration, or (6) any other transaction which results in a substantial diversion of trust funds.[37]

With one exception, the prohibited transactions rule does not

32. *Ibid.*

33. *Compare* I.R.C. § 503(a)(1)(C) *with* Int. Rev. Code of 1939, ch. 38, § 3813(c).

34. The prohibited transactions rule applies to transactions between the employees' trust and (1) the trust's creator or a member of his family, (2) a substantial contributor to the trust or a member of the contributor's family, or (3) a corporation controlled directly or indirectly by the creator of the trust (or substantial contributor thereto) through the ownership of 50% or more of the voting stock (or 50% of the value of all stock). I.R.C. §§ 267(c)(4), 503(c). This is only a "downstream" restriction. That is, the prohibited transactions rule applies to a transaction entered into by the trust with a subsidiary of the employer. However, the rule does not restrict transactions between the trust and the parent of the employer. Rev. Rul. 58-526, 1958-2 CUM. BULL. 269-70.

35. I.R.C. § 503(a)(1). Treas. Reg. § 1.503(d)-1(a) (1958).

The trust's loss of exempt status is effective "only for taxable years after the taxable year during which it is notified" by the Commissioner that the trust has engaged in a prohibited transaction. However, notification is not required where the purpose of the transaction was to divert a substantial part of the trust's corpus or income to non-exempt uses. I.R.C. § 503(a)(2). While the rule's effect is prospective, except for *intentional* violations, the minimum penalty for any breach of the rule is a one year loss of the trust's exempt status. Treas. Reg. § 1.503(d)-1(b) (1958). See Rev. Proc. 57-5, 1957-1 CUM. BULL. 727-28.

36. H.R. REP. No. 2319, 81st Cong., 2d Sess. 42 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 36-37 (1950).

37. I.R.C. § 503(c).

add any investment restrictions to those imposed by the exclusive benefit rule.[38] The only purpose of the prohibited transactions rule is to provide the Commissioner with another and more specific weapon against trusts that engage in unfair transactions.[39] Thus, compliance with the investment restrictions imposed by the exclusive benefit rule meets the requirements of all but one restriction imposed by the prohibited transactions rule. The requirement imposed by the prohibited transactions rule which is not encompassed by the exclusive benefit rule is that loans to the trust's employer must be adequately secured. Something must be pledged by the borrowing employer "in addition to and supporting the promise to pay."[40]

The prohibited transactions rule applies only to transactions between the employer and his employees' trust, while the exclusive benefit rule applies to all transactions entered into by the trust.[41] However, the significant difference between the two rules is their effect on the trust. Disqualification of the trust upon violation of the exclusive benefit rule results in an automatic and immediate loss of the trust's exempt status.[42] On the other hand, violation of the prohibited transactions rule will result in loss of the trust's exempt status only in the succeeding tax year.[43] There is no authority which directs the Commissioner to prefer either rule when both are applicable; hence, if the rules overlap the Commissioner seems to have complete discretion as to which rule he can apply.[44]

C. Unrelated Business Income Rule

The unrelated business income tax subjects an otherwise exempt employees' trust to a tax at individual rates on the income it derives from any unrelated trade or business.[45] In the case of a qualified employees' trust, "unrelated trade or business" means "*any* trade or business regularly carried on" by the trust.[46] Ap-

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38. 4 Mertens, Federal Income Taxation § 25B.04, at 11 n.37 (Supp. 1960) [hereinafter cited as Mertens].

39.

> The prohibited transactions enumerated in section 503(c) are *in addition to and not in limitation* of the restrictions contained in . . . section 401(a).

Treas. Reg. § 1.503(a)-1(a) (1958). (Emphasis added.)

40. Treas. Reg. § 1.503(c)-1(b) (1958).

41. I.R.C. §§ 401(a), 503(c).

42. See note 25 *supra*.

43. See note 35 *supra*.

44. See 4 Mertens § 25B.04, at 11; 6 *id.* § 34.16, at 69-70.

45. I.R.C. §§ 511(b)(2), 512(a), 513(b).

46. I.R.C. § 513(b)(2). The unrelated business income tax also applies to a trade or business regularly carried on by a partnership of which the trust is a member. *Ibid.* See Alexander, *Tax Status of Pension Trusts: Requirements for Maintaining Exemption*, N.Y.U. 13th Inst. on Fed. Tax 435, 454 (1955).

parently the question of whether the business is *regularly carried on* is one of fact.[47] However dividend income, and other income earned from the trust's investments, is not considered to be income derived from the regular operation of a trade or business.[48] Thus, where the trust owns 100 per cent of a corporation's stock, the trust is not subject to a tax on either the dividend income it receives or the corporation's earnings. But even if all the corporation's earnings are payable to an exempt trust, those earnings are still subject to taxation at the corporate level.[49] However, if the trust owns the assets rather than the stock of a going concern, the trust is operating a business and, therefore, is subject to the unrelated business income tax.[50]

II. POSSIBLE INVESTMENTS IN THE EMPLOYER'S BUSINESS

By contributing to a qualified pension or profit-sharing plan the employer will provide his employees with additional compensation and will receive a current tax deduction from his gross earnings. The trust may then invest these contributed funds in the business and thus provide the employer with additional working capital. This has been appropriately referred to as "How to Eat Your Cake and Have It Too."[51]

The trust may use various financial transactions as a means of investing its funds in the employer's business. These transactions may be grouped into the following four categories: (1) acquisition of company stock, (2) acquisition of employer obligations, (3) acquisition of real estate which is subsequently leased to the employer, and (4) acquisition of personal property which is subsequently leased to the employer. Since the Code treats these transactions differently, the specific problems they raise must be individually evaluated in light of the applicable restrictions.[52]

47. Treas. Reg. § 1.513-1(a)(3) (1958).
48. I.R.C. § 512(b).
49. I.R.C. § 502 (feeder organization rule).
50. The requirement that stock ownership be interposed between the employees' trust and the actual business operations was to insure that corporate earnings would be taxed. Congress, obviously, was unwilling to forego the taxation of business income. See Wallis, *Employees' Trusts Under New Code*, 93 TRUSTS & ESTATES 866, 869 (1954).
51. The writer is indebted to Mr. Wood R. Foster of Saint Paul, Minnesota, for this description and for other ideas contained in a paper presented to the University of Minnesota Tax Institute, Dec. 9, 1960.
52. Aside from the question of restrictions, there is the practical question of the differing opportunities various investments may offer the trust. For example, from the trust's view company stock investments protect the trust against inflationary trends while real estate purchases provide safety of principal and adequate return. On the other hand, from the employer's view trust purchases of company stock increase the employer's working

A. INVESTMENTS IN THE EMPLOYER'S STOCK

Trust ownership of the employer's stock[53] has been severely criticized as a violation of the principle of diversification because too much is risked on the success of one venture.[54] Since the trust's basic function is to insure safety of corpus while earning income from its investments, the argument has been made that this objective can be assured only through diversified investments and techniques such as the "dollar-averaging" of stock purchases.[55] Nevertheless, neither the Commissioner nor the courts have disapproved of *prudent* investments in the employer's stock by an employees' trust fund.[56]

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capital. Furthermore, sale-leaseback transactions with the trust not only increase the employer's working capital, but also give him a rent deduction for property that formerly may have been non-depreciable. See Greenfield, *Corporate Benefits in Using the Sale-Leaseback Device*, 37 TAXES 1017, 1020–21 (1959).

53. In recent years there has been a marked shift in the investment policies of employee trusts; investment in preferred stock and securities has given way to increased investment in common stock. SEC, *Survey of Pension Fund Investments*, Statistical Series Release No. 1680, May 31, 1960; SEC, SURVEY OF CORPORATE PENSION FUNDS, 1951–1954, at 11, 27 (1956). Related to this shift has been an increase in trust ownership of the employer's common stock. The most extreme example of an investment in company stock among large publicly-held corporations is the Savings and Profit-Sharing Pension Fund of Sears, Roebuck & Co. employees which "holds more than 26 per cent of the company's outstanding stock." Minneapolis Star, Feb. 24, 1961, § B, p 14, col. 6. This, Sears' board chairman conceded, gives the fund a "controlling interest in the corporation." *Hearings on S. 2054 Before the Subcommittee of the Senate Committee on Banking and Currency*, 84th Cong., 1st Sess. 495–518 (1955). For an analysis of the Sears situation see TILOVE, PENSION FUNDS AND ECONOMIC FREEDOM 60–66 (1959); Business Week, Jan. 31, 1959, pp. 88, 98–99.

54. See authorities cited note 13 *supra*. As the final report of the Douglas subcommittee investigating welfare and pension plans argued,

> the investment of a large share of a pension fund in the employer's assets or securities appears to violate the common sense injunction of not putting all one's eggs in one basket. It appears to us that there are instances . . . where the heavy investment in the employer's securities or assets cannot be justified as a part of prudent management of pension funds. There are a number of cases . . . where over 50 percent of the trust assets are invested in the securities or notes of the employer, and where the concern is a small one and quite possibly subject to wide swings in prosperity or adversity. In such instances, we doubt that these pension funds give real assurance to employees that the pensions to which they are entitled on retirement will actually be theirs.

S. REP. No. 1734, 84th Cong., 2d Sess. 53 (1956). See Griffin, *Outlook for Pension Funding*, 99 TRUSTS & ESTATES 234 (1960).

55. See Scully, *supra* note 18, at 912, 918–19.

56. If there is no evidence of diversion of the trust's funds from the employees' exclusive benefit, the courts have not disapproved an investment of the trust's entire corpus in the employer's stock. H. S. D. Co. v. Kavanagh, 191 F.2d 831 (6th Cir. 1951) (by implication). See Time Oil Co. v. Commissioner, 258 F.2d 237 (9th Cir. 1958); Tavannes Watch Co.

Acquisition of the employer's stock is the least regulated employer-company investment available to an employees' trust. Although there is no direct limit on the amount of such investments, some restrictions do exist in the form of reporting requirements.[57] An annual information return must be filed by the trust so that the Commissioner may determine whether or not the trust "serves any purpose other than constituting part of a plan for the exclusive benefit of the employees."[58] Thus, if the trust is to retain its qualified status after investing in the employer's stock, it must disclose "the reasons for . . . and the conditions under which such investments are made."[59] Compliance with those reporting requirements involving the transmission of factual information presents no problem. However, increase of the employer's working capital is always a factor in the trustee's decision to invest in the business of the employer. Hence, there is a problem in regard to the required disclosure of "the reasons" for the investment.[60] If the trustee indicates that benefit to the employer was one of "the reasons," the trust may be forced to prove that the exclusive benefit rule

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v. Commissioner, 176 F.2d 211 (2d Cir. 1949). However, the Douglas subcommittee on welfare and pension plans recommended further investigation into the propriety of substantial trust investments in the employer's business. S. REP. No. 1734, 84th Cong., 2d Sess. 54 (1956).

57. Section 6033 of the Code requires exempt organizations to file annual information returns. The Commissioner has been given broad discretion over what information the trust must furnish in order to retain its qualified status. In this regard, Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 135-36, requires that the trust must give notification of its acquisition of the employer's stock and the trust must disclose:

1. Balance sheets of the employer as at the close of the last accounting period and for the taxable year ended prior thereto.
2. Comparative statements of income and profit and loss for the last and four prior taxable years.
3. An analysis of the surplus account for the last five years, specifically showing the amount and rate of dividends paid on each class of stock.
4. A statement accounting for all material changes from the latest dates of the aforesaid statements to the date of filing the information.
5. A schedule showing the nature and amounts of the various assets in the trust fund.
6. A statement showing the amount of the investment, the type of investment, the present rate of return, the security if a loan is involved, and *the reasons for the investment.*

(Emphasis added.) But if an advance determination has been requested in accordance with Rev. Proc. 56-12, 1956-1 CUM. BULL. 1029, the disclosure need not be repeated on the annual return.

58. Treas. Reg. § 1.401-1(b)(5)(ii) (1958).

59. *Ibid.*

60. The requirement of a reason for the investment may be analogous to the "business purpose" test which is common in the 1954 Code. See, *e.g.*, Note, 44 MINN. L. REV. 485, 490-92 (1960) (business purpose establishes corporation as a separate taxable entity); 8 MERTENS § 46.09 (business purpose test determines whether consolidated returns may be filed).

has not been violated even though the transaction was in fact proper. Disclosure of factors that independently justify investment in the employer's business—such as soundness of the investment, liberality of the yield, and ability to closely supervise the investment—may satisfy the required statement of reasons.[61]

The employees' trust may acquire company stock by (1) purchases on the open market, (2) direct purchases from the employer, and (3) contributions from the employer.

1. Open Market Purchases

The trust's open market purchase of actively traded employer-company stock at the market price presents no tax problems. This is true whether the stock is listed on an exchange or traded over the counter. The prohibited transactions rule cannot apply because related parties are not involved. Since the fair market value of actively traded stock is its price on the open market, the exclusive benefit rule is not violated; that is, the purchase was fair to the trust.[62] If, on the other hand, the trust purchases company stock that is not actively traded, the purchase price must not exceed the stock's "fair value" or the trust will have violated the exclusive benefit rule.[63]

While open market purchases may indirectly benefit the employer by supporting the market price of the company's stock, this will not result in the trust's disqualification. However, trust purchases of company stock on the open market are of little use to the employer since they do not increase his working capital.

2. Purchases from the Employer

If the company's stock is actively traded, the trustee's direct purchase from the employer at the current market price is not likely to be questioned. But often the stock of a close corporation is not extensively traded. In this case, if the purchase price exceeds

61. The trustee of a pension trust should justify his investments in terms of (1) safety of principal, (2) liquidity (this feature is usually quite limited in case of employees' pension plans because benefit payments can be accurately predicted), (3) certainty of return, (4) adequacy of return, (5) capital appreciation, (6) marketability, (7) collateral value and maturity, and (8) tax consequences. For a discussion of these factors see Howell, *Common Stocks and Pension Fund Investing*, Harv. Bus. Rev., Nov.-Dec. 1958, p. 92. See also note 18 *supra*.

62. Since "fair market value means the price at which a *willing buyer* and *willing seller* would arrive, after negotiation for sale, where neither is acting under compulsion," Estate of Williams v. Commissioner, 256 F.2d 217, 218 (9th Cir. 1958) (Emphasis added), the purchase of stock on the open market would be a purchase at the stock's fair market value. See Elmhurst Cemetery Co. v. Commissioner, 300 U.S. 37, 39 (1937). Compare Treas. Reg. §§ 20.2031-1(b), 25.2512-1 (1958).

63. I.R.C. § 401(a). See text accompanying notes 66-68 *infra*.

the stock's "fair value," the trust's exempt status will be denied on the ground that a prohibited transaction has occurred.[64]

The real problem for the employees' trust is to determine the "fair value" of a close corporation's stock which is not actively traded. Few guides are available.[65] Even when the trust's purchase of employer-company stock is approved in an advance determination letter, the issue of valuation is specifically excluded from the scope of the ruling.[66] Therefore, to protect the trust's exempt status, a defensible determination of the stock's value should be made with the assistance of an independent securities appraiser.

3. Contributions of Company Stock

When company stock is contributed to rather than purchased by the trust, the burden of establishing the stock's "fair value" shifts to the employer.[67] That is, the employer must determine

64. I.R.C. § 503(c)(4). In addition, the trust will have violated the exclusive benefit rule. However, if the value of the stock is underestimated so that the purchase price is less than the stock's "fair value," the trust will not lose its exempt status. "Bargain purchases" by the trust are not contrary to the employees' best interests. While "bargain purchases" will, in some cases, result in the realization of income, Commissioner v. Lobue, 351 U.S. 243 (1956) (employee purchase of company stock); Waldheim v. Commissioner, 244 F.2d 1 (1957) (sale of treasury stock to shareholder), when there is no employment or ownership relationship between the parties, "the general rule is that the purchase of property for less than its value does not, of itself, give rise to the realization of taxable income." Fred Pellar, 25 T.C. 299, 309 (1955), *acq.* 1956–1 CUM. BULL. 5. See 1 MERTENS § 5.13; Greenbaum, *The Basis of Property Shall Be the Cost of Such Property: How Is Cost Defined?* 3 TAX L. REV. 351, 359 (1948). Of course, even if the trust is held to have realized income it would not be taxed thereon unless the trust loses its exempt status.

65. For example, in the valuation of close corporation stock held by an estate, the Commissioner has provided explicit standards:

> Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.
>
> . . . .
>
> It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered.

Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 238. Compare Treas. Reg. § 1.471-4(b) (1958). Furthermore, the trust investment must be "prudent." See notes 17–19 *supra* and accompanying text.

66. Dealings which involve the prohibited transactions rule will be ruled on by the Commissioner in an advance ruling "only if there is a clear indication of value which can be established by reference to recognized sources." Rev. Proc. 56–33, 1956–2 CUM. BULL. 1394, 1395–96. Compare Rev. Proc. 56–12, 1956–1 CUM. BULL. 1029, 1032, where advance rulings for initial qualification of trusts which invest in the employer's stocks are conditioned by the statement: " 'The opinion herein expressed, however, is conditioned on the purchase of such stock at a price not in excess of the fair market value thereof.' "

67. The trust will, however, have to value the stocks it holds if it is

the stock's value in order to justify his current tax deduction.[68] Of course, valuation presents a problem only when the stock is not actively traded. The exclusive benefit rule probably does not apply to the employer's contribution of stock if the employer is not legally obligated to contribute to the trust and the trust can readily dispose of the stock.[69] However, if the employer is under a legal obligation to contribute to the trust, it is likely that the exclusive benefit rule will apply. For example, if the employer overvalues his contribution to the trust, the trust's receipts will be reduced. Since the trust can enforce the employer's legal obligation to contribute to the trust, a failure by the trust to compel the employer to fulfill his obligation would appear to be a violation of the exclusive benefit rule. In addition, the prohibited transactions rule probably applies to the extent it duplicates the limitations imposed by the exclusive benefit rule.[70]

Under the 1939 Code the Commissioner had ruled that a corporation recognized gain if the value of the contributed stock ex-

part of a profit-sharing, stock bonus, or money purchase pension plan. These trust funds must be value inventoried annually on a specified date. Rev. Rul. 57-163, 1957-1 CUM. BULL. 128, 137.

68. I.R.C. § 404(a). For a discussion of the deductibility of the employer's contributions see Note, *Deductibility of Employer Contributions to Employee-Benefit Plans*, 37 MINN. L. REV. 126 (1953).

69. The exclusive benefit rule applies only to the creation and operation of the trust. I.R.C. § 401(a). The trust is a donee rather than an investor if the employer is not obligated to contribute to the trust and if the trust has not had a reasonable time to dispose of the stock. The exclusive benefit rule does not come into effect, in this case, until the trust is an investor.

70. See notes 38-40 *supra* and accompanying text. The adequate security and reasonable interest rate requirements probably do not apply because they are restricted to trust loans to the employer. I.R.C. § 503(c)(1). However, the general provision, § 503(c)(6), undoubtedly would apply if the contribution were to result "in a *substantial diversion* of [the trust's] . . . income or corpus." In addition, there may be a question of whether the contribution of company stock is a "*substantial purchase* of . . . other property for more than adequate consideration." I.R.C. § 503(c)(4). (Emphasis added.) The employer's contribution to the trust is in exchange for the employees' personal services. Hence, in effect, a purchase has occurred since the trust is in the same position as if it had purchased the stock. Compare notes 106-07 *infra* and accompanying text. If this analysis is correct, subsection (4) of the prohibited transactions rule will apply to contributions of substantial amounts of company stock. However, if the prohibited transactions rule can only be applied by subsection (6), it will cover only those contributions that amount to a substantial diversion of trust funds. On the other hand, the employer can argue that subsection (4) does not apply because the contribution is not, in fact, a purchase by the trust. It does not necessarily follow that a transaction that results in the trust being in the same position as an active purchaser is, under the Code, a purchase. Furthermore, the employer can point to the less restrictive coverage of subsection (6) and argue that interpreting the word "purchase" in a liberal manner contradicts the apparent intent of Congress as manifested in the general provision to limit "other transactions" only if there is a substantial diversion of trust funds. This question has not been litigated or interpreted by the Commissioner.

ceeded its adjusted basis.[71] However, section 1032, added by the 1954 Code, provides that the corporation does not recognize gain or loss when it receives "money or other property in *exchange* for" its stock.[72] Thus, the 1954 Code reverses the position taken by the Commissioner under the 1939 Code.[73]

B. INVESTMENT IN EMPLOYER DEBT SECURITIES

As in the case of trust investment in company stock, the exclusive benefit rule does not specifically restrict trust investments in the employer's debt securities.[74] Nevertheless, the prohibited transactions rule subjects trust investment in the employer's debt securities to more stringent regulation than similar investments in company stock. Trust investment in employer debt securities must be adequately secured *and* must return a reasonable rate of interest.[75] Furthermore, problems not encountered in relation to employer contributions of company stock may arise when the employer contributes his debt securities.

1. Adequate Security

Treasury regulations have interpreted the term "adequate security" to mean that the employer's promise to pay must be secured "by something of value" in addition to a demonstration of his ability to make repayment.[76] This additional security must insure that no loss of principal or interest will result from the loan.[77]

71. I.T. 3357, 1940-1 CUM. BULL. 11.

72.

> No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

I.R.C. § 1032.

However, this provision does not alter the effect of International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943). In *Freighting* a subsidiary's contribution of its parent's appreciated stock to an employees' stock bonus plan resulted in a taxable gain to the subsidiary. *Id.* at 313.

73. This view is supported by the Regulations which provide that "the disposition by a corporation of shares of its own stock . . . for money or other property does not give rise to taxable gain . . . *regardless of the nature of the transaction or the facts and circumstances involved.*" Treas. Reg. § 1.1032-1(a) (1956). (Emphasis added.)

74. Treas. Reg. § 1.401-1(b)(5) (1958). See Rev. Rul. 46, 1953-1 CUM. BULL. 287.

"Debt securities" is used in this Note to include such evidences of an obligation to pay money as corporate bonds, mortgages, and promissory notes. See BLACK, LAW DICTIONARY 490, 1522 (4th ed. 1951).

The reporting requirements applicable to investment in company stock also apply to trust investments in the employer's debt securities. See note 57 *supra* and accompanying text.

75. I.R.C. § 503(c)(1).

76. Treas. Reg. § 1.503(c)-1(b) (1958).

77. Treas. Reg. § 1.503(c)-1(c) (Examples (1) and (4)) (1958).

Hence, the additional security obviously must have a fair market value that exceeds the employer's indebtedness to the trust, the interest on the loan, and other related charges.[78] Thus, an accommodation endorsement provides adequate security only if the amount loaned on the basis of the endorsement security was at all times substantially less than the unencumbered assets of the guarantor.[79] Besides accommodation endorsements, additional security may consist of an assignment of a contract, collateral securities, a lien against specific property, or an assurance of repayment by a commercially solvent guarantor or surety.[80] However, unsecured corporate debenture bonds cannot fulfill the adequate security requirement because they are mere evidences of indebtedness. A partnership's subordinated debenture bonds are similarly inadequate since the general partners are fully liable for the firm's debts. The partners' guarantees do not increase the security interest.[81]

The 1954 Code restriction on trust investments in the employer's obligations is inconsistent with the Code's treatment of the trust's investment in company stock. The Code provides that trust investments in the employer's debt obligations must be adequately secured, but investments in company stock are not subject to the same requirement.[82]

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78. See Rev. Proc. 56–33, 1956–2 CUM. BULL. 1394, 1396.

79. See Treas. Reg. § 1.503(c)–1(c) (Example (1)) (1958).

80. Treas. Reg. § 1.503(c)–1(b) (1958); Rev. Proc. 56–33, 1956–2 CUM. BULL. 1394, 1396.

An assignment of monies due under a government contract also constitutes adequate security for a trust's loan to its employer-government contractor. A recent decision of the United States Comptroller General held that an assignment of "moneys due or to become due" under the Assignment of Claims Act of 1940, 54 Stat. 1029 (1940), 31 U.S.C. § 203 (1958), constitutes a valid assignment. 40 Comp. Gen. 174 (1960). See also 36 Comp. Gen. 290 (1956).

81. Treas. Reg. § 1.503(c)–1(c) (Example (1)) (1958). See *What Loans Can an Employee's Trust Make to the Employer?* 4 J. TAXATION 341, 342 (1956).

82. See Levin, *Recent Developments in Pension and Profit Sharing*, N.Y.U. 16TH INST. FED. TAX 23, 33–35 (1958).

The policy reasons for restricting investments in the employer's obligations are identical to the reasons for controlling trust investments in company stock. See notes *54–55 supra* and accompanying text. However, company debentures have priority, in the event of liquidation, over the same stock in which the employees' trust may invest without other security. Heider v. Hermann Sons Hall Ass'n, 186 Minn. 494, 499, 243 N.W. 699, 701 (1932); 6A FLETCHER, PRIVATE CORPORATIONS § 2748 (Wolf perm. ed. rev. repl. 1950); STEVENS, PRIVATE CORPORATIONS 421 (1949). Therefore, it is arguable that investments in the employer's obligations should be subject to less rather than more restrictions. In addition, trust investments in employer debentures may also provide significant benefits to the employees' trust.

For example, 1 per cent higher interest return on a pension fund over a long period of time could enable the company to improve the bene-

The adequate security requirement has produced absurd results. As of October 31, 1956, sixteen per cent of the American Telephone & Telegraph Company's employees' pension trust fund was invested in Bell System operating companies' debt securities.[83] These securities were bought in good faith and at fair prices prior to the issuance of the regulations defining "adequate security." The trustees felt that the securities were an attractive investment. In fact, Bell System debt securities constituted sixteen per cent of all high grade publicly offered corporate debt issues for the previous five years. Yet, in order to avoid the prohibited transactions rule, the regulations required the trust to acquire additional security. As one fund trustee commented, "It is difficult to understand how the disposition of these high-grade securities with the consequent loss of nearly $500,000 can possibly be in the interests of the fund and its employee beneficiaries."[84]

In the Technical Amendments Act of 1958,[85] Congress engrafted limitations on the adequate security requirement to correct the anomalous results under the 1954 Code. As an *alternative,* section 503(h) insures that the equivalent of an arms-length transaction occurs and that the employer's obligations constitute a reasonably safe investment.[86] For example, if the trust purchases company debentures from a securities underwriter at the public offering price and at least 50 per cent of the debenture issue is held by unrelated parties, the employer does not need to provide

> fits to their employees by about a fourth. That is, if you assume the fund is going to earn 2½ per cent compound interest and instead it earns 3½ per cent interest, the extra 1 per cent, long-term compounded, would enable the company to improve the pension benefits to the employees by almost one-fourth without it costing the company another dime.

Hearings Before the Senate Finance Committee on Technical Amendments Act of 1958, 85th Cong., 2d Sess. 195 (1958).

83. *Hearings Before the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee,* 84th Cong., 2d Sess. 359–67 (1956).

The Bell System operating companies are subsidiaries of the American Telephone & Telegraph Co. *Id.* at 362. Hence, § 503(c) applies to the parent trust's purchase of the subsidiary's debentures—a "downstream" transaction. See note 34 *supra.*

84. *Hearings Before the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee,* 84th Cong., 2d Sess. 362 (1956).

85. 72 Stat. 1606, 1629–31 (1958).

86. First, subsection (h) imposes conditions designed to insure that the purchase was the equivalent of an arms-length transaction. I.R.C. § 503 (h)(1). Second, the trust's acquisition of the employer's obligation must not exceed 25 per cent of any debenture issue and at least 50 per cent of that issue must be held by persons independent of the employer. I.R.C. § 503(h)(2). Third, not more than 25 per cent of the trust's assets may be invested in the employer's obligations. I.R.C. § 503(h)(3). See *Hearings Before the Senate Finance Committee on the Technical Amendments Act of 1958,* 85th Cong., 2d Sess. 57–58 (1958).

additional security if immediately following the investment the trust does not hold more than 25 per cent of either that issue of company debentures or of the company's total debt obligations. Section 503(i) provides an *exception* to the adequate security requirement if the employer is prohibited by federal law or regulation from pledging as additional security more than one-half the value of his assets.[87] This provision was adopted to assist unincorporated stock brokerage firms which could not meet the adequate security requirement because of federal statute and regulation.[88]

2. Reasonable Interest Rates.

In addition to requiring adequate security, the prohibited transactions rule requires that trust loans to the employer return a reasonable rate of interest.[89] While the regulations do not attempt to define a reasonable rate of interest, the rate would undoubtedly be sufficient if it were commensurate with the rate that the trust could obtain on similar investments in nonemployer obligations. Thus, one commentator has suggested that if the trust's loan to the employer provided for an interest rate of 4 per cent and the prevailing rate were 5 per cent, the loan would probably constitute a prohibited transaction even though the lower interest rate would otherwise have been "reasonable."[90] If the interest rate received by the trust is unreasonable because it is too low, the trust loses its exempt status.[91]

On the other hand, if the trust charges the employer an unreasonably high interest rate, the prohibited transaction rule is,

87. Three requirements must be met. First, the employer must be prohibited by federal law or regulation from encumbering his assets. I.R.C. § 503(i)(1). Second, the loan must have the written approval of a trustee who is independent of the employer and such approval must not have been previously denied. I.R.C. § 503(i)(2). Third, the overall trust investment in the employer's obligations without adequate security cannot exceed 25 per cent of the value of the trust's assets. I.R.C. § 503(i)(3).

88. See S. Rep. No. 1983, 85th Cong., 2d Sess. 51–52 (1958). The restrictions applicable to unincorporated stock brokerage firms are contained in § 8(a) of the Securities Exchange Act of 1934, 48 Stat. 888 (1934), as amended, 49 Stat. 704 (1935), 15 U.S.C. § 78h(a) (1958), and § 5(a) of the Federal System Board of Governor's regulation T, 12 C.F.R. § 220.5 (a) (1959).

89. I.R.C. § 503(c)(1).

90. See *What Loans Can an Employee's Trust Make to the Employer?* 4 J. Taxation 341–42 (1956).

As previously noted, the prohibited transactions rule does not encompass unsecured loans by the trust fund to the employer's parent corporation. Rev. Rul. 58–526, 1958–2 Cum. Bull. 269. Thus, the reasonable rate of interest requirement in § 503(c)(1) would not apply to such a transaction. Nevertheless, a trust loan at less than reasonable rates to the employer's parent would undoubtedly disqualify the trust on the ground that the transaction would not be for the exclusive benefit of the employees.

91. See text accompanying note 43 *supra*.

of course, not violated. The employer, however, will be deemed to have made a *constructive contribution* to the employees' trust to the extent of the excess interest.[92] It is, nevertheless, to the trust's advantage to set the rate too high rather than too low. The penalty for erring on the "high side" is merely a denial of the employer's interest deduction for the excess amount, not a loss of the trust's tax-exempt status.[93]

If, because of the constructive contribution to the pension trust, the employer's total contributions exceed his allowable deduction,[94] section 404(a)(1)(D) allows a carryover of unused deductions to succeeding tax years.[95] In 1953 the Commissioner ruled, under a similar 1939 Code "carryover" provision,[96] that even if the constructive contribution exceeds the deductible limit, the trust is not disqualified.[97] However, if the constructive contribution is part of a design to circumvent the Code's limitations on deductible contributions, the employer will be deprived of the carry-over provisions.[98]

3. *Contributions of the Employer's Debt Securities*

Additional questions are raised when the employer contributes his debt securities to the employees' trust. The first question is whether the employer may deduct the contribution in the year of transfer, or whether he must postpone the deduction until the obligation is liquidated. A second question is whether the adequate security and reasonable rate of interest requirements apply to such employer contributions.

Section 404(a) provides that the employer's contribution is deductible only after it is "paid" to the trust. Analytically, the employer's contribution of his debt securities constitutes either a present payment *or* an enforceable obligation to make a future con-

92. See text commencing at note 115 *infra* and Rev. Rul. 46, 1953-1 CUM. BULL. 287, 288.

93. While there is no requirement that the interest deduction be reasonable, Dorzback v. Collison, 195 F.2d 69, 72 (3d Cir. 1952); Arcade Realty Co., 35 T.C. No. 33 (Nov. 10, 1960), payments in excess of a reasonable amount to a related party are not interest payments because they are not a result of the indebtedness. See 4 MERTENS §§ 26.03, 26.04. Compare Rev. Rul. 46, 1953-1 CUM. BULL. 287, 288.

94. The limits on allowable deductions for contributions to pension trusts are contained in § 404(a)(1). For similar restrictions on contributions to stock bonus and profit-sharing trusts, see I.R.C. § 404(a)(3)(A). Compare I.R.C. § 404(a)(7).

95. See I.R.C. § 404(a)(3)(A) for a similar rule applicable to stock bonus and profit-sharing trusts. *Cf.* I.R.C. § 404(d).

96. Int. Rev. Code of 1939, ch. 1, § 23(p), 53 Stat. 15. See also I.R.C. § 404(d) which allows the carryover of unused deductions that arose under the 1939 Code.

97. Rev. Rul. 46, 1953-1 CUM. BULL. 287-88.

98. *Ibid.*

tribution. The Court of Appeals for the Third Circuit, in *Dick Bros. v. Commissioner,*[99] held that the transfer of a *check* to a pension fund trustee was a present payment.[100] However, prior to the *Dick* case, the Tax Court had supported the Commissioner in *Logan Engineering*[101] and held that the transfer of a *negotiable note* did not constitute a present payment. When the latter issue was presented in *Sachs v. Commissioner* (the combined *Sachs and Slaymaker* case),[102] the Court of Appeals for the Third Circuit refused to follow the *Logan* rule. The Third Circuit ruled that a present payment occurred when the negotiable note was delivered. However, the Commissioner has not acquiesced in *Sachs and Slaymaker.*

The prohibited transactions rule, however, poses an additional problem. The *Dick* and *Sachs and Slaymaker* decisions were decided under the 1939 Code which did not apply the adequate security requirement to employees' trusts. Therefore, the second question, whether the employer's contribution of his debt securities to the trust must comply with the adequate security and reasonable rate of interest requirements, remains unanswered. Although the case law is silent on this point, there is no reason to believe that these provisions are inapplicable to contributed employer debt securities.[103] The employer's satisfaction of his legal obligation[104] to contribute to the trust constitutes compensation for the em-

99. 205 F.2d 64 (3d Cir. 1953), *reversing* 18 T.C. 832 (1952).

100. On the other hand, *conditional contributions* are not deductible until actually paid unless the condition attached is the Commissioner's initial approval of the plan. Rev. Rul. 60-276, 1960 INT. REV. BULL. No. 34, at 11. See Branham Co., 19 CCH Tax Ct. Mem. 168, 174 (1960).

101. 12 T.C. 860 (1949), *appeal dismissed,* Oct. 4, 1949 (7th Cir.). The court declined to follow the reasoning of Modie J. Spiegel, 12 T.C. 524 (1949), which held that the delivery of a check was payment of a charitable contribution. The court also refused to extend the rationale of Musselman-Hub Brake Co. v. Commissioner, 139 F.2d 65 (6th Cir. 1943), which held that the delivery of a negotiable note by a solvent maker constituted payment of interest or business expenses.

102. 208 F.2d 313 (3d Cir. 1953), *remanding* 11 CCH Tax Ct. Mem. 882 (1952), and *reversing* 18 T.C. 1001 (1952). See Time Oil Co. v. Commissioner, 258 F.2d 237, 240 (9th Cir. 1958) where the court agreed with the *Sachs and Slaymaker* decision.

103. Section 503(c)(1), the adequate security and reasonable interest rate requirements, applies only when the employees' trust "*lends* any part of its income or corpus." Although the employer's contribution of an unsecured note technically is not a loan, there is no question that in substance a loan has occurred. *But cf.* Lauinger v. Commissioner, 60-2 U.S. Tax Cas. ¶ 9964 (2d Cir. 1960).

104. The Code does not require the employer to be legally obligated to the trust in order for the pension or profit-sharing plan to be qualified. However, § 9(a) of the National Labor Relations Act requires the employer to bargain on the establishment of pension plans. Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948). Hence, it is likely that negotiated pension plans will stipulate that the employer is obligated to contribute to the trust fund.

ployees' services; therefore, the employers contribution may be regarded as a purchase which must comply with the prohibited transactions rule.[105] Furthermore, it is arguable that if the trust continues to hold the employer's obligations after having a reasonable opportunity to sell or exchange them, the trust is in the same position as if it had purchased the obligations.[106] By not disposing of the employer's debt securities, the trust may be actively investing in them. Therefore, unless the contributed debt obligations are adequately secured and pay a reasonable rate of interest, the trust may lose its exempt status.[107]

C. REAL PROPERTY TRANSACTIONS

Trust investment in the employer's business may also be accomplished by the acquisition of real property which is subsequently leased to the employer. The trust may acquire real property in three ways: (1) the trust may purchase realty from an unrelated party, (2) the trust may purchase realty from the employer, or (3) the employer may contribute realty to the trust.[108]

1. Purchases of Real Property from an Unrelated Party

The trust's purchase of real property from an unrelated third party must, of course, be for the exclusive benefit of the employees. Thus, the price must not exceed the property's fair market value. Otherwise, there are no significant tax hurdles to be overcome by the trust fund. A trust purchase of real property from an unrelated third party is not within the prohibited transactions rule since there is no identity of interest between the buyer and seller.[109]

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105. See note 70 *supra.*

106.

> If an organization subject to section 503(c) purchases debentures issued by a person specified in section 503(c), the purchase is considered, for purposes of section 503(c)(1), as a *loan* made by the purchaser to the issuer on the date of such purchase. For example, if an exempt organization subject to section 503(c) makes a purchase through a registered security exchange of debentures issued by a person described in section 503(c), and owned by an unknown party, the purchase will be considered as a *loan* to the issuer by the purchaser.

Treas. Reg. § 1.503(c)-1(b) (1958). (Emphasis added.) Thus, if the purchase of employer's debt securities from an unrelated party is considered a *loan* to the employer, the employer's contribution would seem to be in the same category.

107. Compare note 69 *supra.*

108. The investment must, of course, be authorized by the trust instrument or local law, and it must also meet the prerequisites of a sound investment. However, the reporting requirements applicable to investments in company stock or the employer's obligations, notes 57-60 & 74 *supra,* do not apply to the trust's real estate transactions with the employer.

109. I.R.C. § 503(c).

2. Purchases of real property from the employer

The prohibited transactions rule applies to trust purchases of real estate from the employer. Consequently, the trust will lose its exempt status if it purchases such property for more than adequate consideration.[110] However, even if the purchase is for an adequate consideration,[111] the employer should be aware of other tax problems. First, the transaction is between related parties and if the property's selling price is less than the employer's basis for the property, the employer's loss will not be recognized.[112] Thus, the employer is denied the loss deduction otherwise available when he sells property.[113] On the other hand, if the property's selling price exceeds the employer's basis, he will have to recognize gain.[114]

If the selling price is the same as the employer's basis, there would appear to be no taxable gain. But if the property has appreciated the Commissioner could argue that the portion of the property's fair market value which exceeds the selling price is a *constructive contribution* by the employer.[115] If the employer's contributions have already reached his deductible limit, the constructive contribution will not give rise to an immediate deduction.[116] Nevertheless, this appreciation may result in immediate taxable gain to the employer.[117] Thus, the employer will have sacrificed a present economic gain (the amount of the appreciation) without a corresponding alteration of the tax consequences. The increase in the employer's working capital will not be as great as it would have been if the selling price equaled the property's fair market value.

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110. I.R.C. § 503(c)(4).

111. In order to assure that the purchase is for an adequate consideration, the property should be valued by an independent appraiser.

112. I.R.C. § 267. The trust's basis for the property is cost. I.R.C. § 1012.

113. I.R.C. § 165. The employer will not be able to recognize this loss deduction unless he can transfer the property's basis to "exchange property" I.R.C § 267(d)(2).

114. I.R.C. § 1001.

115. If the property's value is less than the employer's basis, the trust's purchase for a price set at basis would constitute a prohibited transaction. I.R.C. § 503(c)(4).

116. The deduction arising from the constructive contribution may, of course, be deducted in succeeding tax years. See notes 94–95 *supra* and accompanying text.

117. See text accompanying notes 124–32 *infra*. Section 1032, which permits corporate non-recognition of gain realized from dealings in its own stock, only applies to the exchange of *stock* for money or other property; therefore, the employer cannot use § 1032 to avoid the recognition of gain realized from the transfer of *real property*. See note 72 *supra* and accompanying text.

3. Contributions of the employer's real estate

As in the contribution of company stock, the prohibited transactions rule may apply to the employer's contribution of real property to the employees' trust if the transaction results in a substantial diversion of trust funds or if the transaction amounts to a purchase by the trust.[118]

As noted earlier, the employer's contribution is deductible by him if the contribution complies with section 404. Section 404 does not restrict the employer's contribution in form to money or securities.[119] Hence, the employer's contribution of a fee interest in real property is deductible up to the property's fair market value. However, a reservation in the deed may raise a question of whether or not the contribution complies with section 404; that is, was it "*paid* into the pension trust."[120] For example, in *Colorado Nat'l Bank*[121] the employer conveyed six contiguous lots in the city of Denver to the fund trustees subject to a lease-back and a repurchase option. The Commissioner argued that the contribution was not paid to the trust because cash or its equivalent would not be paid until the employer exercised his repurchase option.[122] However, analogizing from the area of charitable contributions, the Tax Court held that the bank had made a "present contribution of property which represented a payment in kind rather than cash, but a payment, nevertheless, within the words and intent of the applicable statutory provisions."[123]

The employer's deduction is limited to the fair market value of the contributed property and, even if fair market value is less than the employer's basis, loss is not recognized. However, when the fair market value of contributed property exceeds the employer's basis, there is a question of whether gain must be recognized. The taxpayer who contributes property (other than money) to a charity is allowed a deduction in the amount of the property's fair market value and is not required to recognize gain.[124] Thus,

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118. See note 70 *supra*.

119. See Treas. Reg. § 1.404(a)-1(b) (1956) (by implication).

120. I.R.C. § 404(a)(1).

121. 30 T.C. 933 (1958), *acq.*, 1959-1 CUM. BULL. 3.

122. The court found that the rental charge and the option price were reasonable and that the rentals did not, in fact, reduce the option price. The Commissioner's argument was based on the contention that the contribution was, at best, a future obligation to make a cash payment to the pension trust when the repurchase option was exercised. However, this argument ignores the fact that the trust could have sold the property, subject to the lease and option, to a third party. Colorado Nat'l Bank, 30 T.C. 933, 934-35 (1958).

123. *Id.* at 936.

124. Campbell v. Prothro, 209 F.2d 331 (5th Cir. 1951) (charitable contribution of calves); White v. Broderick, 104 F. Supp. 213 (D. Kan. 1952) (charitable contribution of wheat); *cf.* Elsie SoRelle, 22 T.C. 459

the question apparently depends on whether an employer's contribution in kind and the analogous charitable contribution in kind should be subject to the same non-recognition rule. In *United States v. General Shoe Corp.*,[125] the Court of Appeals for the Sixth Circuit held that the employer's contribution of appreciated property to his employees' pension trust resulted in the recognition of gain to the extent of the appreciation, even though the employer had no legal obligation to contribute to the trust.[126] Although the Sixth Circuit had previously ruled that appreciated property transferred in a divorce settlement was incapable of being assigned a fair market value,[127] the court in *General Shoe* readily distinguished that decision.[128] The court measured the value of the employer's economic benefit by the fair market (appraised) value of the transferred property.[129] The employer argued that no gain had been realized. In reply, the court stated that "the taxpayer realized exactly the same gain here by transferring the real estate as it would have, had it sold the real estate for fair market (or appraised) value and contributed the funds to the trust."[130] The court's analysis seems incomplete because it failed to consider the rule applied, in analogous circumstances, to charitable contributions in kind when appreciated property is transferred to the donee. While the policy reasons for encouraging charitable contributions also apply to employer contributions to employees' trusts, the court could have found that the two situations are distinguishable. The rule applied to charitable contributions in kind can be justified by the fact that the donor has received only an intangible satisfaction.[131] On the other hand, in *General Shoe* the employer received the employees' personal serv-

(1954), and Estate of Farrier, 15 T.C. 277 (1950), where gifts of wheat and cattle to the donor's children did not result in taxable gain to the donor. See Treas. Reg. § 1.170–1(c) (1958); Rev. Rul. 55–138, 1955–1 CUM. BULL. 223.

125. 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961).

126. 282 F.2d at 11. However, the court examined only the trust instrument; it did not examine the terms of the collective bargaining agreement which may have obligated the employer to contribute to the trust.

The court found the reasoning of International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943), to be persuasive. In *Freighting* the employer recognized capital gain on the transfer of appreciated stock to the employees' stock bonus plan. *Id.* at 313.

127. Commissioner v. Marshman, 279 F.2d 27 (6th Cir. 1960).

128. 282 F.2d at 13.

129. *Ibid.*

130. *Id.* at 12. This argument is supported by Helvering v. Horst, 311 U.S. 112 (1940), where the Supreme Court held that "realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him." *Id.* at 115.

131. See 5 MERTENS § 31.01.

ices in exchange for the contributed property.[132] Therefore, despite the court's limited analysis, its decision seems correct.

4. Leases of Trust-Owned Real Estate to the Employer

Trust ownership of real property is useful to the employer only when the property is leased to him.[133] This transaction may be beneficial to both the trust and the employer because (1) the trust will retain the property when the lease expires, (2) the lease transaction may constitute a prudent investment which returns an adequate yield, and (3) the employer will acquire additional working capital.[134] Since the lease transaction is between related

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132. Although the court stated that "the taxpayer is correct in its contention that it did not receive a tangible benefit," United States v. General Shoe Corp., 282 F.2d 9, 12 (6th Cir. 1960), this statement ignores the fact that the employer's deduction is conditioned on his receipt of the employer's services. As the Regulations point out,

> contributions may . . . be deducted under section 404(a) only to the extent that they are ordinary and necessary expenses during the taxable year . . . *and are compensation for personal services actually rendered.*

Treas. Reg. § 1.404(a)-1(b) (1956). (Emphasis added.) See I.R.C. § 404 (a); *Some Uses of Appreciated Property Bring Realization of Gain and Tax*, 14 J. TAXATION 77 (1961).

133. The employer benefits from a leaseback because it allows an immediate rent deduction which may be more than the depreciation allowance on the same property. That is, the transaction converts the cost of a fixed asset, which may be nondepreciable (land), into a tax deduction. See Colorado Nat'l Bank, 30 T.C. 933, 934 (1958).

The employer's sale of property to the trust is not advisable if there is no leaseback. If the employer would not have been able to sell the property to an unrelated party at the same price received from the trust, a sale to the trust would violate the prohibited transactions rule. On the other hand, if the price is adequate and no leaseback is sought by the employer, a disposition to an unrelated party is preferable because the employer's working capital is increased to the same extent and the valuation problem is avoided. See text accompanying note 110 *supra*.

Section 512(b)(3) excludes real property rentals from the unrelated business income tax. However, this exception does not apply to real property rentals in the case of a "business lease." I.R.C. § 512(b)(4).

In Century Electric Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), the seller was denied a capital loss upon the exchange of a fee for a 95 year lease because the transaction constituted a "like kind" exchange. See I.R.C. 1031(a). However, when the exchange is between the employer and his employees' trust, the loss is denied recognition by § 267(a), even though the leaseback is for less than 30 years. Thus, because of § 267, the *Century Electric* problem does not arise in connection with a sale-leaseback between the employer and the employees' trust.

134. See Greenfield, *Corporate Benefits in Using the Sale-Leaseback Device*, 37 TAXES 1017, 1019 (1959); Business Week, Jan. 31, 1959, pp. 88, 97–98.

Of course, the employer should be aware of the similarities between a sale-leaseback transaction and a mortgage transaction. The sale-leaseback should be used only after having compared its advantages and disadvantages with a mortgage of the property. For example, when the employer mortgages property, his working capital is increased to the extent

parties, it will be carefully scrutinized.[135] If the rental paid by the employer is too low, or if, because of the property acquisition, the trust fund does not have sufficient liquidity, the trust will have violated the exclusive benefit rule.[136] On the other hand, if the rental charged the employer exceeds the prevailing rate for comparable property, the Commissioner will disallow the employer's "rent" deduction to the extent of the excess.[137]

If the employer and his employees' trust include a purchase option in the lease agreement, they should carefully consider the terms of the option. If the option price is less than the property's fair market value and the rent payments approximate the prevailing rental rate, the trust will lose its exempt status on the ground that a prohibited transaction has occurred.[138] On the other hand, when an option price less than the property's fair market value is coupled with rent payments that exceed the prevailing rate, the Commissioner may treat the transaction as an installment sales contract[139] and disallow the employer-lessee's "rent" deduction.[140] In the latter situation, the Commissioner's theory is that the payments are not for the employer's use of property but rather to acquire ownership thereof. Due to these problems, one writer

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of the mortgage, and no capital gain is recognized—even if the mortgage exceeds the employer's basis for the property, Woodsam Associates v. Commissioner, 198 F.2d 357 (2d Cir. 1952). I.R.C. § 1001 requires a "sale or disposition." In addition, the employer-mortgagor retains title to the property while he acquires an interest deduction for the interest payments. I.R.C. § 163(a). However, in the case of a sale-leaseback for cash the employer's working capital is increased by the property's market value. While gain realized from the sale must be recognized and the employer does not retain title, the rent deductions will normally exceed the interest payments on a mortgage. I.R.C. § 162(a)(3).

135. *E.g.*, Midland Ford Tractor Co. v. Commissioner, 277 F.2d 111, 114 (8th Cir. 1960); J. J. Kirk, Inc., 34 T.C. 130, 137 (1960). When the transaction is between unrelated parties the rental rate is determined in an arms-length transaction and therefore is not limited to a reasonable amount. J. J. Kirk, Inc., *supra* at 136–39; Stanley Imerman, 7 T.C. 1030, 1037 (1946). See 4 MERTENS § 25.110.

136. See text accompanying note 27 *supra*. Since the lease of realty may constitute, in effect, a loan by the trust, the trust may have to comply with the reasonable interest rate requirement. I.R.C. § 503(c)(1).

137. *E.g.*, J. J. Kirk, Inc., 34 T.C. 130, 136–39 (1960); Stanley Imerman, 7 T.C. 1030, 1037 (1946). See 4 MERTENS § 25.110.

138. I.R.C. § 503(c)(5).

139. *E.g.*, Haggard v. Commissioner, 241 F.2d 288, 289 (9th Cir. 1956); Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, 321–22 (7th Cir. 1956).

140. *E.g.*, Beus v. Commissioner, 261 F.2d 176, 181 (9th Cir. 1958); Haggard v. Commissioner, *supra* note 139; Breece Veneer & Panel Co. v. Commissioner, *supra* note 139, at 322–24. When the rent deduction is denied, only the improvements standing on the land will provide the employer with a depreciation deduction; the land is non-depreciable. I.R.C. § 167.

has recommended that purchase options be avoided.[141] However, a more logical and equally cautious approach is available. The trust may enter into a lease agreement if the option price is set at the property's fair market value and the rental payments approximate the prevailing rate. That is, the rental payments must be a condition of the employer's continued possession of the property.[142]

Finally, the parties must insure that the transaction does not constitute a "business lease" taxable under the Code's unrelated business income tax provisions. Failure to avoid the "business lease" classification will expose the trust to taxation at individual rates on the allocable net rental income.[143] Moreover, if the trust's rental yield from the leased property[144] is rendered less than a reasonable rate because of the unrelated business income tax, the trust may have violated the exclusive benefit rule.[145]

A business lease occurs when (1) the trust leases real property for more than five years and (2) an indebtedness, which the trust would not have incurred except for the lease, exists at the end of the trust's tax year.[146] Furthermore, if the indebtedness exists, a lease of five years *or less* will constitute a business lease *after* the employer occupies the property for more than five years under successive leases.[147] In that case, the tax is imposed only in the sixth and succeeding years in which the employer continues to occupy the property.[148]

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141. Greenfield, *supra* note 134, at 1019.

142. Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, 324 (7th Cir. 1956).

143. I.R.C. §§ 511(b), 512, 514. Allocable net rental income consists of a percentage of the rent received under the business lease less a percentage of the deductions allowed in § 514(a)(3) for the expenses of ownership. The percentage figure applied is determined by dividing the amount of the business lease indebtedness at the close of the tax year by the property's adjusted basis at the close of the tax year. I.R.C. § 514(a)(1). See Wallis, *Employees' Trusts Under New Code*, 93 TRUSTS & ESTATES 866, 869 (1954).

144. The leased property includes the personal property leased with the real property. I.R.C. § 514(d).

145. The exclusive benefit rule may be violated on the ground that such a lease transaction is not prudent; it benefits only the employer. I.R.C. § 401(a). The prohibited transactions rule, however, is *not* violated because the trust will have *received* a reasonable rent on its investment before taxes. I.R.C. § 503(c)(1).

146. I.R.C. § 514(b), (c). See Address by Isidore Goodman, Western Pension Conference (Los Angeles Chapter), Nov. 17, 1960, in 2 CCH PENSION PLAN RUL. ¶ 11106.

147. I.R.C. § 514(b)(2).

148. I.R.C. § 514(b)(2)(B).

D. PERSONAL PROPERTY TRANSACTIONS

As in the case of real property, the employees' trust may acquire ownership of personal property by purchase from an unrelated party, from the employer, or by a contribution in kind from the employer. The trust may then lease the personal property to the employer.

With the exception of the business lease rule, the tax problems connected with real property transactions are equally applicable to personal property transactions. However, in contrast to the exempt status provided for income received from real property leases which are not within the business leases category,[149] income derived from a lease of personal property may be subject to the unrelated business income tax. The definition of "unrelated trade or business" contained in section 513(b) must be read in conjunction with section 512(a) to determine what constitutes a qualified trust's "unrelated business taxable income."[150] When read together, these two sections define "unrelated business taxable income" as the gross income derived from *any* trade or business regularly carried on by the trust, minus the allowed deductions. Thus, had the Code provided no exceptions to the unrelated business taxable income provision, rent payments received from the lease of either realty or personalty would be subject to the unrelated business income tax (assuming the ownership and lease of property constitutes a "business regularly carried on").[151] However, the Code does provide specific exceptions to this tax. Rent payments received from real property (including personal property leased with the real property) are specifically excluded;[152] leases

149. I.R.C. § 512(b)(3).

150.

> The term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the exceptions, additions, and limitations provided in subsection (b).

I.R.C. § 512(a)

> The term "unrelated trade or business" means, in the case of . . . (2) a trust described in section 401(a) . . . which is exempt from tax under section 501(a); any trade or business regularly carried on by such trust . . . .

I.R.C. § 513(b).

151.

> A trade or business is regularly carried on when the activity is conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity. An activity may be regularly carried on even though its performance is infrequent or seasonal.

Treas. Reg. § 1.513-1(a)(3) (1958).

152. "There shall be excluded [from unrelated business taxable income]

of personal property are not so excluded. Therefore, trust income regularly received from the lease of personal property is subject to the unrelated business income tax.[153]

In a recent case before the Tax Court, *Cooper Tire & Rubber Co. Employees' Retirement Fund*,[154] an employees' trust borrowed $200,000 which it combined with $144,830 of its own funds and purchased rubber-making machinery from an unrelated third party; this machinery was leased to the employer. The Commissioner assessed a tax deficiency on the employees' trust for nonpayment of unrelated business income tax. In response, the employees' trust petitioned the Tax Court for a redetermination. The trust contended that where the trustee had no duties to perform other than to collect the rent the trust was engaged in a *passive* investment rather than the operation of a trade or business[155] and, therefore, no unrelated business income tax was due.

all rents from real property (including personal property leased with real property) . . . ." I.R.C. § 512(b)(3). Other exclusions include dividends, interest, royalties and gains or losses from the sale of non-business property.

153. In the Senate Finance Committee's explanation of the Internal Revenue Act of 1950, the committee reported that "the tax on unrelated business income does not apply to dividends, interest, royalties, and *rents* (other than certain rents on property acquired with borrowed funds)." S. REP. No. 2375, 81st Cong., 2d Sess. 30 (1950). (Emphasis added.) The committee justified the exclusion of "most rents" by noting that

> they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.

Id. at 30–31. Thus, personal property rentals are arguably not subject to the unrelated business income tax. However, in the technical discussion of the specific provisions of the unrelated business tax section, the committee's report was more precise. The exclusions from unrelated business net income were limited to

> all dividends, interest, annuities, and royalties, and the deductions directly connected therewith . . . .
>
> (b) In general, rents from real property (including personalty leased therewith) and the deductions directly connected therewith are also excluded. . . . The term "rents from real property" does not include income from the operation of a hotel but does include rents derived from a lease of the hotel itself. Similarly, income derived from the operation of a parking lot is not considered "rents from real property." *Income received from a business of renting personal property is excluded under section 422(a)(3)* [now I.R.C. § 512(b)(3)] *only if the personal property is leased with real property.*

Id. at 108. From this statement it is clear that Congress intended to impose the unrelated business income tax upon rental income received by employees' trusts from the lease of personal property which is not leased with real property.

154. 36 T.C. No. 5 (April 17, 1961) reported in ¶ 36.5 P-H TAX CT. REP. 1961 [hereinafter cited as Cooper].

155. Brief for Petitioner, pp. 9–10, Cooper. The trust's contention was contrary to the Commissioner's ruling that a lease of railroad tank cars is a taxable investment. Rev. Rul. 60–206, 1960–1 CUM. BULL. 201.

The trust's theory was that it had loaned capital directly to the equipment-user instead of lending the funds to an equipment leasing company which would in turn rent the equipment to Cooper Tire & Rubber Company.[156] The Commissioner contended that this is precisely what Congress intended to restrict. He argued that the unrelated business income tax was "directed primarily at the problem of unfair competition by tax exempt organizations [by which they could] . . . purchase property for leasing and lease for more beneficial rates than an ordinary business."[157] As an additional argument, the Commissioner pointed out that the lease of a single piece of real property has been held to constitute a trade or business.[158]

The Tax Court, in *Cooper,* held that the lease of personal property was "governed by the same considerations" that control real property rentals; therefore, the trust was subject to the unrelated business income tax on its income. However, the acquisition and lease of personal property may still be an attractive investment for employees' trusts. The advantages offered by real property rentals[159] apply equally to the trust's lease of personal property. Personal property transactions provide additional advantages in that the trust's dollar investment is more flexible than in real property investments; thus, advantageous investment opportunities are available to smaller trust funds. Furthermore, personal property leases usually earn a more liberal return than other trust investments in the employer's business.[160] Therefore, the high yield secured from the trust's lease of personal property to the employer may justify this investment although the trust is subject to an unrelated business income tax.[161]

CONCLUSION

While the underlying principle of the tax rules governing the operation of employees' trusts is to insure that tax benefits are available only to trusts that protect the employees' interests, the Commissioner has, in practice, modified this approach. Instead of denying exemption to any trust dealing with the employer—which a strict application of the exclusive benefit rule arguably requires —the Commissioner has permitted such investments. If the trust's dealings with the employer meet the standards of an arms-length

156. Brief for Petitioner, p. 16, Cooper.
157. Brief for Respondent, p. 10, Cooper. See note 153 *supra.*
158. *E.g.,* Reiner v. United States, 222 F.2d 770, 772–73 (7th Cir. 1955); Anders I. Lagreide, 23 T.C. 508, 512 (1954).
159. See note 134 *supra* and accompanying text.
160. See Cooper at pp. 36–65—36–66.
161. *Ibid.*

transaction, the trust may purchase the employer's stock, obligations, or property. Instead of making annual cash contributions to the trust, the employer can contribute his stock, property, or debt securities to his employees' trust. In addition, the employer may finance an expansion of his business by leasing trust-owned property from the employees' trust.

In the case of trust investments in company stock, the Commissioner has been extraordinarily liberal; except for the exclusive benefit rule, no effective controls exist. The Commissioner's liberality in permitting trust investments in the employer's stock *may* be based on his aim of encouraging the declaration of dividends by close corporations so that earnings are taxed at the corporate level.[162] For example, in the case of trust investments in company stock, if the employer is to deduct his contributions to the trust, he will have to distribute the corporation's earnings as dividends instead of as payments to shareholders in the form of salary.[163] Otherwise, the trust is not being operated for the employees' exclusive benefit. Furthermore, if the trust has only a minority interest in the corporation, the trustee's failure to compel the corporation to declare a dividend[164] may be a breach of his fiduciary duty. Because of a possible conflict of interest in this case, the practice of having officers of the employer-company act as trustees of the employees' trust would seem to be unwise.

The Commissioner's allowance of other trust investments in the employer's business may also be intended to increase the amount of working capital available to close corporations. The trust can, for example, purchase property from the employer and lease it back. In this case the employer increases his working capital by (1) the purchase price paid by the trust, and (2) the tax saving that accrues to the employer because rent payments are deductible.[165] In addition, the Commissioner's permissive approach provides the employer with a method by which he can finance his employees' trust without a depletion of his investment capital.

While the Commissioner's permissive interpretation of the tax law applicable to investments of employees' trust funds may encourage close corporations to declare dividends and to provide methods by which additional working capital can be acquired, it is

162. See also 1 O'NEAL, CLOSE CORPORATIONS § 2.04 (1958); 2 *id.* §§ 8.13–.14.

163. *Ibid.*

164. See 1 *id.* § 8.08 (power of minority shareholders to compel the declaration of dividends).

165. Of course, this increase in the employer's working capital is limited by three factors: (1) the fact that the employer no longer owns the factory, (2) the employer's loss of his depreciation deduction, and (3) the cost of the rent payments made by the employer.

questionable whether the consequent reduction in the protection of the employees' interests is desirable. Unfortunately the Code does not specifically deal with this problem. At the least, Congress should provide the Commissioner with some specific guides to clarify the policy to be followed. Thus, if the Congress were to favor protection of the employees' interests, a specific limit (as in the case of trust investments in the employer's obligations) on the amount of company stock that a qualified trust may acquire should be established.