2 T.C. 924 (1943)

An employee must include the full amount of annuity payments in their gross income when the annuity contract was purchased entirely by the employer, and the employee did not include the cost of the annuity in their income in the year of purchase.

Summary

Charles L. Jones, a retired oil company employee, received substantial annual retirement payments under a contract purchased and fully paid for by his employer. The cost of the contract was never included in Jones's gross income. The Tax Court addressed whether these payments should be fully included in Jones's gross income or treated as annuities under Section 22(b)(2) of the Internal Revenue Code, allowing for a portion to be excluded. The court held that the full amount must be included in gross income, as Jones never paid taxes on the cost of the annuity when it was purchased. The court further held that Jones did not have to include the amount he would have received if he had not elected to receive a smaller payment so that his wife would receive payments after his death.

Facts

Charles L. Jones worked for Atlantic Refining Co., later Vacuum Oil Co., and then Socony Vacuum Oil Co. until his retirement in 1937. In 1931, his employer entered into a group contract with Metropolitan Life Insurance Co. to provide retirement annuities for employees. For pre-1931 services, the employer paid the full cost of the annuity. Jones completed 40 years of service in 1931 and became entitled to a life annuity of $41,250 at age 65. Jones elected to receive a reduced annuity of $33,000, with his wife to receive $24,882.53 annually if she survived him. The employer paid a total of $541,592.22 towards Jones's retirement annuities.

Procedural History

Jones initially included the annuity payments in his gross income for 1937 and 1938 but later filed claims for refunds, arguing no part of the payments was taxable. The Commissioner of Internal Revenue determined deficiencies in tax, including the $33,000 in Jones's gross income. The Commissioner then amended his answer, seeking an increased deficiency by arguing Jones should have included $41,250 in gross income each year. The Tax Court addressed both the initial deficiency and the Commissioner's claim for an increased deficiency.

Issue(s)

1. Whether a retired employee must include in gross income the full amount received as retirement payments under an insurance contract purchased and paid for entirely by the employer, or whether a portion can be excluded under Section 22(b)(2) of the Internal Revenue Code.

2. Whether the employee must include in gross income not only the amount actually received but also the amount that would have been received had he not elected a lesser amount to provide for his wife after his death.

Holding

1. Yes, because the employee did not include the cost of the annuity in his gross income in the year it was purchased, he must include the full amount of the annuity payments in his gross income.

2. No, because the employee exercised a right under the contract to receive a reduced amount to provide for his wife, the amount he did not receive is not included in gross income.

Court's Reasoning

The court reasoned that Section 22(b)(2) of the Internal Revenue Code had always been construed to limit exclusions to the one who actually made the payment or their donee-beneficiary, typically a blood relative. The court stated, "no tribunal has ever held that an employee is entitled to deduct from his gross income the premium or consideration paid by his employer for an annuity unless the circumstances surrounding the payment were such as to require the employee to include the cost of the annuity in his gross income in the year it was purchased." The court rejected Jones's argument that the 3% rule applied because the payments were compensation for services. The court distinguished cases where the employee constructively received income when the employer purchased the annuity. Regarding the increased deficiency claim, the court found that Jones exercised a contractual right to receive a reduced annuity for his life and provide for his wife. The court reasoned it would be unfair to tax Jones on income he did not receive, especially since his wife would be taxed on the payments she received after his death. The court stated, "it is obvious that every dollar paid under the contract will bear its fair burden of tax."

Practical Implications

This decision clarifies the tax treatment of employer-purchased annuities under Section 22(b)(2) of the Internal Revenue Code (prior to the 1942 amendment). It highlights that employees cannot exclude a portion of annuity payments from gross income if their employer fully funded the annuity, and the employee did not pay taxes on the cost of the annuity when purchased. The case underscores the importance of taxing the cost of benefits at some point. The decision also demonstrates that taxpayers are not always required to include income that they could have received, but instead directed to another individual.

