Hills v. Commissioner, 23 T.C. 256 (1954)

Payments received by a beneficiary from a retirement system due to an employee's death after retirement are not considered capital gains under Section 165(b) of the 1939 Internal Revenue Code but are instead treated as ordinary income.

Summary

The case concerns the tax treatment of a death benefit received by a beneficiary from the New York State Employees' Retirement System. Judge James P. Hill, the beneficiary's father, elected a retirement option ensuring that any remaining balance from his annuity would be paid to a designated beneficiary upon his death. After his death, his daughter, the petitioner, received a lump-sum payment. The Commissioner determined that the payment was taxable as ordinary income, while the petitioner argued for capital gains treatment. The Tax Court sided with the Commissioner, ruling that Section 165(b) of the 1939 Internal Revenue Code applied, differentiating between payments related to an employee's separation from service and payments made because of death after separation from service.

Facts

Judge James P. Hill retired on January 1, 1949, choosing a retirement option that included a death benefit provision. He died on June 9, 1950. His daughter, the petitioner, was the designated beneficiary and received a lump-sum payment of $36,608.83 from the New York State Employees' Retirement System on June 26, 1950. Of this amount, $8,970.41 was tax-exempt representing the decedent's unrecovered cost, and the remaining $27,638.42 was the subject of the dispute.

Procedural History

The Commissioner of Internal Revenue determined a tax deficiency based on the petitioner's treatment of the death benefit as capital gains. The petitioner challenged this determination in the United States Tax Court. The Tax Court reviewed the case based on the submitted facts.

Issue(s)

Whether the lump-sum payment received by the petitioner is taxable as ordinary income or as long-term capital gains under Section 165(b) of the Internal Revenue Code of 1939?

Holding

Yes, the payment is taxable as ordinary income because Section 165(b) of the 1939 Internal Revenue Code does not provide for capital gains treatment of lump-sum payments to beneficiaries of covered individuals who die after terminating their employment.

Court’s Reasoning

The court focused on the interpretation of Section 165(b) of the Internal Revenue Code of 1939. The Commissioner contended that the language of the code clearly treats payments made on account of death as ordinary income if the death occurred after retirement. The petitioner argued for capital gains treatment based on the 1954 Internal Revenue Code section 402, which provided capital gains treatment for payments on account of death. The court differentiated that the 1954 code extended, but did not clarify the scope of, the 1939 code. The court cited the legislative history of the 1954 Code to highlight Congress’ intent to rectify the inequity of treating similar distributions differently based on whether they were from trusteed or insured plans, or whether the employee had died before or after retirement. The court noted that under the 1939 Code, payments made due to death after separation from service were not eligible for capital gains treatment. The court did not consider additional arguments raised for the first time in the petitioner’s brief because the issues were not properly pleaded.

Practical Implications

This case clarifies the tax treatment of death benefits paid from retirement systems under the 1939 Internal Revenue Code, differentiating between distributions due to separation from service and those due to death after retirement. This has implications for how beneficiaries of retirement plans should treat these payments for tax purposes, as it emphasizes that the timing and nature of the payment significantly affect the tax classification. This ruling highlights the importance of the specific language of the governing tax code and how it applies to specific scenarios. Furthermore, it underscores the significance of properly pleading issues before the court.