Trebotich v. Commissioner, 57 T. C. 326 (1971)

A qualified pension plan under section 401 of the Internal Revenue Code must be funded, with contributions accumulated in a trust or similar entity independent of the employer.

Summary

Thomas Trebotich received a lump-sum payment under an early retirement plan established by the ILWU and PMA. The plan required employers to contribute funds to a trust, which were then immediately distributed to employees. The Tax Court held that the plan did not qualify under section 401 of the IRC because it was not funded, as the trust did not accumulate funds but acted merely as a conduit. Consequently, the lump-sum payment was taxable as ordinary income, not as a long-term capital gain. The decision emphasizes the necessity for qualified pension plans to have funds accumulated in a trust independent of the employer.

Facts

Thomas Trebotich, a longshoreman, retired in 1967 and received a lump-sum payment under an early retirement plan established by the International Longshoremen's and Warehousemen's Union (ILWU) and the Pacific Maritime Association (PMA). The plan was part of a collective bargaining agreement aimed at mechanizing west coast shipping operations. Employers contributed to a mechanization fund, which was then transferred to a vesting benefit trust. The trust immediately distributed the funds to eligible employees upon retirement. Trebotich reported the lump-sum payment as a long-term capital gain, while the Commissioner of Internal Revenue argued it should be taxed as ordinary income.

Procedural History

The Commissioner determined a deficiency in Trebotich's federal income tax for 1967, arguing the lump-sum payment should be taxed as ordinary income. Trebotich petitioned the Tax Court, which heard the case and issued its decision on December 9, 1971. The court's decision was that the payment was taxable as ordinary income.

Issue(s)

1. Whether a pension plan qualifying under section 401 of the Internal Revenue Code must be funded.
2. Whether the early retirement plan established by the ILWU and PMA constituted a funded plan under section 401.

Holding

1. Yes, because the legislative history and purpose of section 401 indicate that qualified pension plans must accumulate funds in a trust or similar entity

independent of the employer to protect employees' retirement benefits.
2. No, because the vesting benefit trust did not accumulate funds but merely acted as a conduit, receiving and immediately distributing the funds to employees, thus not meeting the funding requirement of section 401.

Court's Reasoning

The court analyzed the legislative history of section 401, noting that Congress intended qualified plans to be funded to ensure the protection of employees' retirement benefits. The court defined "funded" as the accumulation of contributions in an entity beyond the employer's control prior to the payment of benefits. The court found that the vesting benefit trust did not meet this requirement because it did not accumulate funds but merely acted as a conduit, receiving funds from the PMA and immediately distributing them to employees. The court rejected the argument that the PMA's collection of funds constituted funding, as the PMA acted as an agent of the employers and did not hold funds independently. The court also noted that the plan's structure did not align with the statutory intent of ensuring that funds were accumulated for the benefit of employees. The dissenting opinion argued that the trust did have a corpus and should be considered funded, but the majority's interpretation prevailed.

Practical Implications

This decision clarifies that for a pension plan to qualify under section 401, it must be funded, meaning contributions must be accumulated in a trust or similar entity independent of the employer. This ruling impacts how pension plans are structured and administered, emphasizing the need for plans to have a mechanism for accumulating funds before distributing benefits. It also affects tax planning for both employers and employees, as distributions from non-qualified plans cannot receive favorable tax treatment such as long-term capital gain status. Subsequent cases have reinforced this requirement, and it remains a critical consideration in designing and evaluating pension plans. Employers must ensure their pension plans meet the funding requirement to qualify for tax deductions and provide tax benefits to employees.

