DISTRICT OF COLUMBIA TAX COURT

FILED

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District of Columbia
Tax Court

CHESTER W. and ELEANOR R. HESLER, Petitioners,	)	
v.	)	DOCKET NO. 2076
DISTRICT OF COLUMBIA, Respondent.	)	

FINDINGS, CONCLUSIONS AND DECISION

This case involves one aspect of our D. C. income tax on annuity and pension receipts. In general, such receipts are taxed under the "3% rule": taxpayer includes in his gross income 3% of the aggregate cost to him of the annuity or pension -- "total amount you paid in" according to the D. C. income tax form -- and the remainder is tax-free, year by year, until the cost is recovered. Thereafter, the annuity or pension is taxable in full. The "3% rule" was copied into our local tax statute from the identical text of the 1939 Internal Revenue Code, Sec. 22(b) (2) (A), as added by Sec. 120(d) of the Revenue Act of 1942. The "3% rule" was replaced by new and different exclusionary provisions in the 1954 Internal Revenue Code, and is now obsolete so far as the Federal income tax is concerned.

For an understanding of the case, two more general observations should be made. First, the principle at work under the "3% rule" is, that taxpayer should get back, income-tax free, the capital that he has invested in the pension or annuity fund. The 3% taxed during the years of such pay-back is roughly the income presumed to have been earned on such capital under conservative 1939 standards of "return". Second, any contributions to the fund made by the employer have presumably been

deducted from his taxable income -- in the early days, as his ordinary and reasonable expenses, later, under the 1939 Internal Revenue Code as amended. A matter of symmetry is involved: the employer gets a deduction, the employee should bear the tax, at least when he starts to collect the untaxed income contributed by the employer; otherwise the income escapes all tax. This is in general the respondent's theory of the case at bar, which is not tenable on the special facts which follow.

The facts. Mr. Hepler was an employee of the International Labor Office, an affiliate of the United Nations, from 1949 until his retirement January 10, 1963. He worked and resided in Geneva, Switzerland until he retired, at which time the Heplers first came to live in the District. He was covered by the U. N. Joint Staff Pension Fund, a fully vested pension plan, to which he had contributed a total of $11,642.08 and to which the ILO had contributed a total of $22,741.07.

In 1963 and 1964, Mr. Hepler received as pension from the Fund a total of $8,029.48, apparently reported to and accepted by the District as nontaxable income. In 1965, 1966 and 1967, respectively, Mr. Hepler's pension amounted to $4,725.99, $5,029.44 and $5,269.44. On audit, deficiencies were found for those years by respondent, on two conflicting theories which need not be set out, since a recomputation will be made under this decision. Respondent's basic and continuing contention is, that only Mr. Hepler's contribution to the Fund constituted his "cost" to be recovered tax-free. Mr. Hepler claims that this amount plus the ILO contribution of $22,741.07, or a total of $34,383.15, is his "cost". Respondent has waived any contentions regarding the $8,029.48 received tax-free in 1963 and 1964, except for $698.52 ("$349.26 for each of the years 1963 and 1964" -- this is 3% of Mr. Hepler's $11,642.08

contribution), and starts with a "remainder of cost" to be received tax-free, beginning in 1965, of $10,943.56 ($11,642.08 minus $698.52). Letter of D. C. Finance Office of November 15, 1969; see also respondent's brief, predicated solely on the deficiencies there found. Against this "remainder of cost" Mr. Hepler's 1965, 1966 and 1967 pension receipts, less the taxable 3%, were applied, resulting in a "remainder of cost", in 1967, of only $1,886.65, or a taxable excess (over the $5,269.44 received in that year) of $3,382.79. (Idem.)

Of course, following the respondent's theory, all pension receipts for 1968 and subsequent years would be taxable in full. Under Mr. Hepler's theory, the "remainder of cost" as accepted by respondent, or $10,943.56, is to be added to the ILO contribution of $22,741.07, for a total of $33,684.63 to be recovered 97% tax-free in his pension receipts beginning with 1965. Note that Mr. Hepler did not report any taxable receipts from his pension in 1965, 1966 or 1967; on recomputation, deficiencies based on 3% of his pension receipts in those years will result.

The D. C. Code provisions. The complicated provisions of sections 47-1557a (b) (2) (A) and (B), which govern the case at bar, need not be set forth. Both are, as respondent says (Br. 4) "virtually identical with section 22(b) (2) of the Internal Revenue Act [i.e., Code] of 1939." Both were enacted as part of the D. C. income tax by Act of July 16, 1947, 61 Stat. 335, Art. I, title III, section 2.[1] It follows that for purposes of specific reference to the "Federal Internal Revenue Code"[2] and in

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1/ The D. C. tax laws have never been legally codified; references to the D. C. Code, where the tax laws are to be found, are for convenience.

2/ D. C. Code 47-1557b (a) (11), incorporated by reference into 47-1557a (b) (2) (B).

the general interpretation of the governing provisions, we look to the 1939 I.R.C. as it existed in 1947, and to cases and authorities thereunder, as well as to any implications concerning the prior law to be derived from subsequent changes in the I.R.C. Important changes in such provisions made by the Revenue Act of 1942 are a part of our D. C. income tax laws; important changes made by the 1954 I.R.C. and the Revenue Act of 1962 are not part of our law.

Section 47-1557a (b) (2) (A) says in effect that there shall be excluded from gross income 97% of receipts up to "the aggregate premiums or consideration paid for such annuity", and respondent relies on the Jones case, infra, holding that this phrase does not cover premiums or consideration paid by the employer. Petitioner focusses on Section 47-1557a (b) (2) (B), which, much oversimplified and in general, says two things: first, if the employer's contributions are deductible from his Federal income tax, then the basis of the exclusion is only the employee's contributions; second, if the employer's contributions are not so deductible, then the employee must (a) include the contributions in his income as they are made, and (b) add them to the exclusion when he starts to receive his annuity. The general idea is that in the case of 1939 I.R.C. section 23(p) pension plans, income tax on the employer's contributions is deferred until the annuity falls in, but is not waived. But as to such "qualified" plans, and also as to "unqualified" plans, Mr. Kepler's situation forms an unusual exception, as we shall see.

Cases and points. The applicable principles are laid down in I.R.Mem. 71, 1952 - 2 CB 170, 172, stating that an annuity distribution is excludible —

> * * * only to the extent the payment represents (a) a return of the employee's own contributions or (b) amounts actually contributed by the employer * * * on account of personal services of the citizen employee rendered abroad during a period qualifying under section 116(a) of the Code. * * * To compute the portion of each of such payments which is thus includible as income * * * the 'consideration paid' for the annuity for purposes of section 22(b) (2) of the Code may be taken as including not only amounts contributed under the plan by the employee, but in addition, amounts which represent contributions by the employer on account of * * * foreign service of the employee during a period qualifying under section 116(a) of the Code, if the employee is a citizen.

There is no question but that Mr. Hepler's foreign service qualifies under the 1939 I.R.C. section 116(a). If deemed to have a foreign situs, the Fund nonetheless has the same tax treatment as domestic pension funds. See CCH 1970 Fed. Income Tax Reporter, sec. 2627.02.

I.R.Mem. 71 is followed in Rev. Rul. 56-123, 1956-1 CB 60, 61, under the 1954 I.R.C. (the "consideration paid" for an annuity includes amounts which would have been excludible from the employee's taxable income because of the earned income exemption of the 1939 Code sec. 116(a)); and in Rev. Rul. 59-278, 1959-2 CB 174, 176 (the excludible pension or annuity receipts comprise (a) the part attributable to earned income of the employee while abroad, and (b) the employer contributions while the employee was nontaxable in the United States as a bona fide resident abroad).

Merton's Law of Federal Income Taxation, Vol. 8, Sec. 45.71f, p. 235, summarizes the applicable rule:

> * * * prior to the 1962 Act, an employee was not taxable on receiving a pension or annuity on retirement, even though he was then a resident of the United States, to the extent that the payment was attributable to an employer's contribution with respect to services rendered abroad while a bona fide resident there or while present there 17 out of 18 months. (Citing S.Rep. No. 1881, 87th Cong. 2d Sess. pp. 74 - 75.)

See also Merten's op. cit., sec. 6A. 05, pp. 21 - 22, (1) there is no requirement that the premiums for an annuity be paid for by the annuitant to be considered part of his investment therein; (2) insofar as the employee excludes from income tax income earned abroad, the employer's contributions to the employee's pension are part of the investment in the contract.

The tax exclusion for purposes of the Federal law was changed by section 11(c) (2) of the Revenue Act of 1962, P.L. 87-834, 87th Cong. 2d Sess., approved October 16, 1962, for taxable years after December 31, 1962. However (idem, p. 23) --

> This change in law does not apply to employer contributions to provide pension or annuity credits, to the extent such credits are attributable to services performed before January 1, 1963, and are provided pursuant to pension or annuity plan provisions in existence on March 12, 1962, and on that date applicable to such services.

Where employees are exempt from Federal income tax because their income is earned outside the United States or "for other reasons",[3/] the employer's annuity contributions up to December 31, 1962 are part of the consideration paid by the employee for his annuity for purposes of the Federal income tax. CCH op. cit. sec. 864.03; rule applied in Crispin v. United States, 200 F.2d 99, 100 (CA 9), Hackett v. Comm'r., 159 F.2d 121 (CA 1), and Wimbish v. United States, 267 F.Supp. 597 (W.D. Ky.).

Respondent relies on Charles L. Jones, 2 T.C. 924 (1943), acq. 1944 CB 15, where an executive of an oil company was given an insurance company life annuity costing $453,131.74, all paid for by the oil company and never reported by the executive as

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3/ For instance, pre-1939 contributions of State and local governments to teacher and other employee pension funds. Rev. Rul. 56-82, 1956-1 CB 59.

taxable income. Beginning January 1, 1937, he received $33,000 per annum proceeds of the annuity, and was assessed thereon for 1939 and 1940. Held: taxable to him in full under Sec. 22(a) of the 1939 Code and not taxable as a Sec. 22(b) (2) annuity under the "3% rule"; the term "aggregate premiums or consideration paid for such annuity" in the latter subsection means "the amount paid by them [the insured or annuitant and his beneficiaries] for the policies". 2 T.C. at 933. And, as respondent says, Sec. 22(b) (2) of the 1939 Code is identical with D. C. Code Sec. 47-1557a (b) (2) (A).

Aside from the obvious factual differences, the case is distinguishable as a matter of law. It arose under the 1939 Code prior to the amendment made by Sec. 162(c) of the Revenue Act of 1942, adding Sec. 22(b) (2) (B) to that Code. The additional section, "Employees' Annuities" is Sec. 47-1557a (b) (2) (B) in the identical language of the D. C. income tax, as enacted by the Act of July 16, 1947.

The Jones case is still good law in particular situations, for instance where the payments are not really an annuity (Wolfe, 8 T.C. 689), are additional compensation (Hackett, supra and 5 T.C. 1325), see also Card, 20 T.C. 620, affd. 216 F.2d 93, and Higgs, 16 T.C. 16, affd. 184 F.2d 427. It is true, as the respondent says (Br. 7), that "in the case of qualified plans the employee's investment in that plan will normally consist only of his own contribution". But the case at bar is abnormal and special. The rule adding the employer's contribution to the employee's "cost" (recoverable tax-free) makes sense in the present case, in terms of symmetry, because the ILO contributions to Mr. Hepler's annuity have never been subject

to, and therefore have never been postponed from, Federal income tax or D. C. income tax. There is therefore no reason why they should incur either Federal or D. C. tax, when paid out by the ZLO to Mr. Hepler.

Decision under Rule 30, subject to recomputation pursuant to the foregoing.

Robert M. Weston
Judge

Served as follows:

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