

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 279

November 2, 1964

PENSION PLAN: DEDUCTIONS BY SUCCESSOR CORPORATION FOR PAST CREDITS AND FOR EXCESS CONTRIBUTION CARRY OVER

Syllabus:

As of the close of business on November 30, 1954, X acquired 23 banking businesses that had been operating as subsidiaries of Y. The acquisitions were accomplished by means of the purchase of the assets of the banking companies. Y owns 76.28 percent of the stock of X.

At least one of the 23 banks acquired had no pension plan for the employees. Others did have a pension plan, but benefits for past services of employees were not fully funded at the time of the transfer.

The sales agreements made no specific reference to the pension or annuity plans. However, an adjustment was made in the purchase price in the case of 14 of the acquisitions. In the settlement of the price, the value placed upon the goodwill of the seller was reduced by the amount necessary to fully fund the cost of benefits for employees with respect to past services rendered to the transferor companies.

The employees taken over were covered thereafter under group annuity contracts. In 1955, and thereafter X made contributions under the pension plan to fund all past service credits of employees, including services rendered before acquisition to the banks taken over at November 30, 1954. X claimed a deduction under Section 24601 for the amounts contributed under the plan within the limitations of the section.

Certain of the banks acquired by X which had pension plans had excess contributions from prior years which were allowable as deductions in succeeding income years under Section 24601(d).

Where a business is acquired by the purchase of the assets of the transferor.

(1) Are contributions to fund the cost of credits for services rendered to the predecessor corporation deductible by the acquiring corporation?

(2) Can the excess contributions of the predecessor corporation be carried over to the acquiring corporation?

(1) Section 24601(d) allows a deduction to the employer for the cost of

funding past service credits as well as current service credits. Neither this section nor any other provision of the Personal Income Tax Law deals with the matter of services rendered to a predecessor employer, and there appears to be very little authority dealing directly with the question.

A special ruling letter of the Commissioner of Internal Revenue, dated October 23, 1944, would seem to support the allowance of the deduction. The ruling, as summarized at 613 CCH Standard Federal Tax Reports P2647.60, states that in computing the cost of past service credits for employees of the successor business who were also employees of the predecessor, the successor may properly include the cost of credits for periods during which such employees were in the service of the predecessor where such credits are provided under a plan which meets the exemption requirements and is duly adopted by the successor company. According to references to the ruling in various articles, it provides that the cost of past service credits is deductible regardless of whether the predecessor business was acquired in a taxable or a tax-free transaction. N.Y.U. Institute on Federal Taxation, 1957, page 1202; idem, 1959, page 958; 10 Tax Law Rev. 537. In a Federal ruling, where the acquired corporation was a subsidiary, the cost of funding past service credits was ruled to be deductible. Revenue Ruling 58-165, Cum. Bull. 1958-1, page 209, 211, ruled that if a subsidiary corporation is liquidated and its assets, liabilities, and employees are transferred to the parent corporation, the parent corporation, as the complete successor to the subsidiary corporation, will be entitled to deductions for contributions to the trust under the plan to fund benefits for the transferred employees with respect to all covered services rendered by such employees to either the parent corporation or the subsidiary corporation or both, whether such services were rendered on, after, or prior to the effective date of the plan and trust. In a court case dealing with direct employee compensation, rather than pension contributions, it was held that compensation paid retroactively by a successor company for services performed for a predecessor company was allowable as a deduction to the successor. U.S. v. Minneapolis & St. Louis Railway Co., 260 Fed. 2d 663. Based upon the foregoing, it is my opinion that, except as discussed hereafter, the successor corporation which itself pays the contributions under the plan may be allowed to take the deduction.

Section 24601 provides that pension contributions are not deductible under Section 24343 (relating to trade or business expenses) but if they satisfy the conditions of the section, they are deductible under Section 24601. The significant conditions of Section 24343 are that the amount claimed as a deduction must be an "ordinary and necessary" expense of carrying on a trade or business. To be deductible, therefore, the contributions by a successor on account of services to a predecessor must be ordinary and necessary. The courts, however, seem to have little difficulty in finding that compensation or pension contributions paid by the successor corporation are ordinary and necessary where economic circumstances or the desire to preserve employee loyalty and goodwill justify the payment. U.S. v. Minneapolis & St.

Louis Railway Co., supra; Scoville Mfg. Co v. Fitzpatrick, 215 Fed. 2d 567. I doubt that it could be successfully maintained in the instant case that the conditions are not satisfied.

The foregoing conclusions are probably applicable only in those cases where the cost of funding past service credits is not taken into account in settling the purchase price. With respect to the 14 acquisitions in which the value of goodwill was reduced in settling upon the purchase price, the opposite decision is indicated as discussed hereinafter, although no precise authority has been found.

It is clear that the successor cannot claim a deduction for the payment of a final and definite or reasonably determinable liability of the predecessor. Such payment, if assumed by the successor, is a part of the purchase price, a capital expenditure. In the instant case, however, the rule is not necessarily applicable because the predecessor banks had no obligation at the time of sale to fund the cost of past service credits of their employees. The obligation to make payments under the pension plan for the employees' past service to the predecessor banks was created by X, the successor, at the time it acquired the businesses. If no consideration were given to this anticipated expense in arriving at the purchase price, it must be concluded that the expense was incurred by X and is deductible by it. U.S. v. Minneapolis & St. Louis Railway Co., supra. However, in that case, the court, in deciding that the expense was deductible by the successor, relied on the trial court's finding that the successor, had not agreed to discharge a liability of the predecessor; and, in addition, the court especially noted that the record did not disclose the slightest indication that the expense was given consideration by the parties in arriving at the sale price. The court also noted that there was no prior agreement or legal obligation to pay the expense. The instant 14 sales differ in that the purchaser apparently agreed to pay the cost of funding the past service credits and the sales price was adjusted accordingly.

Since the court relied on the absence of any such adjustment of price as one of the grounds of its decision, it is concluded that such an adjustment permits a contrary result.

Based upon the foregoing, it is concluded that:

- (a) If the purchase price is adjusted for the amount necessary to fund the cost of past services rendered to the predecessor corporation, the successor corporation is not allowed a deduction for the payment of such amounts.
- (b) If there is no indication that such cost was taken into consideration in determining the purchase price, the successor corporation may deduct the amounts paid, within the limitations of Section 24601.
- (c) Certain other situations suggested in the opinion request can be held to

come within (a) only if additional facts can be developed that would support a determination that the purchase price did, in fact, reflect the cost to the successor corporation of funding the past service credits.

(2) The second problem raised in the opinion request is whether the successor may claim a deduction for the excess contribution carryover of the predecessor. Under Section 24601, the deduction is allowed to the employer that actually makes the contribution under the pension plan. There is no express provision in the Personal Income Tax Law covering the question of carrying over an employer's excess contribution to a successor.

Where the business is acquired by the successor through purchase of the assets of the predecessor, the two corporations are deemed to be separate employers, and the successor cannot avail itself of the payments made by the predecessor. See Rev. Rul. 58-193, Cum. Bull. 1958-1, page 208. The general rule is well established that in the case of the purchase of assets there can be no carrying over of expenses or losses because of the lack of any continuity of ownership between the seller and the purchaser.

It has been held that, in the absence of specific statutory provisions, an excess pension contribution could be carried over in a statutory merger, but not in any other type of reorganization. Internal Revenue Bureau, Pension Service Ruling No. 62, issued May 5, 1950, 4 Mertens, Law of Federal Income Taxation, Sec. 25B.45; and see, Newmarket Mfg. Co. v. U.S., 233 Fed. 2d 499; Senate Report No. 1375, 84th Cong., 2d Sess., 1956 U.S. Code & Adm. News p. 2210, Cum. Bull. 1956-1, page 295. Since a carryover may not be had in a reorganization other than a statutory merger, a fortiori a carryover is not permitted in the case of a purchase and sale.