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ON "QUALIFYING" PENSION PLANS

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The renewed interest of businessmen in pension plans for their employees again demands the lawyer's attention. It is the purpose of this paper to supplement my previous article on this subject in *Dicta*,[1] confining myself here to the narrow problem of "qualifying the plan."

First, however, I should restate some of the reasons for employers' interest in pension plans.

(a) The employer's contributions to a qualified plan are, within the limits set by Section 23(p), I. R. C., deductible from gross income. With the return of the excess profits tax on corporations, a "contribution-dollar" may therefore cost a corporate employer as little as 18¢.[2]

(b) The employer's contribution to a qualified trust is not "income" to the employee, though the pension itself is income to him when received by him.

(c) A pension plan may be so drawn as to be exempt from salary and wage stabilization restrictions.[3]

(d) The goodwill and increased work-enthusiasm of employees, produced by a pension plan, may be worth a great deal to the employer, yet, cannot be measured in dollars and cents.

(e) The "contribution-dollar," already reduced in cost by the tax feature,[4] may actually cost the employer even less, and may cost a corporate employer nothing. The reason why this can happen is this: in a corporation, even a closed corporation, stockholders who are also employees may participate in the plan. The cash values or funds accumulated in the pension fund for the benefit of stockholders-employees in effect diminish and may totally offset the cost of the "contribution-dollars."

2. Where the plan takes the form of a trust, as it usually does and usually should do, general trust law, e.g. regarding the settlor, beneficiary, trustee, the trust res, and possibly [5] the rule against perpetuities, must be complied with.

It is obviously impossible in this article to cover all the trust rules that may be involved, and I can only refer the reader to the well-known texts by Scott and Bogert. The latter has a sample pension trust in Section 1124(a) which to some may, though it should not, obviate reading of the preceding 1123 sections.

A warning is in order against the tendency of neglecting trust law over the understandable desire to comply with the tax rules. In the following situation such neglect may be fatal under both.

Under Section 23(p) (1) (E), I. R. C., proper contributions

[1] September, 1943, pp. 223 et seq.
[2] Or 30c if the overall tax limit of 70% is considered.
[3] General Salary Regulation 6; General Wage Regulation 21.
[4] *Supra*, (a).
[5] Not now in Colorado: COLO. STAT. ANN., Chapter 40, Section 9 (2).

to a qualified pension trust are deductible "in the taxable year when paid," and

> a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made within sixty days after the close of the taxable year of accrual.

Now, assume a taxpayer on the accrual and calendar year basis. A pension trust instrument is executed on December 31, 1950, and it is provided that payment of the contribution must be made within sixty days. The taxpayer does make the payment within the sixty days, and deducts it on his 1950 tax return. This seems at first glance perfectly proper. But on more careful consideration, there appears the serious question whether a trust exists at all in 1950. A trust *res* is necessary to create a valid trust in Colorado,[6] and a valid trust *in 1950* is a prerequisite for a deductible contribution to such trust on the 1950 tax return. It might be argued that the "claim" of the trust against the taxpayer constitutes the trust *res* until it has actually been paid. The difficulty with this argument is, however, the fact that the trust instrument usually does not so state, and that the Commissioner may not recognize such claim as a sufficient trust *res* for tax purposes.[7] The trouble of the taxpayers involved in the citations just preceding would have been avoided had the trust law been more carefully consulted.

3. It is however true that the drafter of a pension trust has an invisible collaborator looking over his shoulder in the Commissioner of Internal Revenue who, applying and interpreting section 165, I. R. C., tells the draftsman what to put in or leave out of such trust, if it, and contributions to it, are to be tax-exempt.

(a) A plan is tax-exempt under the following conditions:[8]

(aa) There must be a written pension plan which is definite and is communicated to the employee. The plan need not be, but may be, separate from and in addition to the trust agreement. Where a separate "plan" and "trust" are drawn, it should be stated which of the two is to control in case of conflict.

(bb) The plan must be for the exclusive benefit of, i.e. for the ultimate distribution to, the employees or their beneficiaries. In order to have clear terminology it is advisable to call the employees covered by the plan "participants" and reserve the term "beneficiaries" to the objects of the participants' bounty.

(cc) Section 165 (a) (3) (A), I. R. C., prescribes certain percentages of employees which seemingly must be met to qualify a pension trust as tax-exempt. But many qualified trusts do not meet these percentages. They must then qualify under Section 165(a) (3) (B), i.e. they must set up a classification "found by

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[6] Bank of America v. Scully, 92 F. 2d 97 (10th Cir. 1937); Scott Section 2.6; Section 66.

[7] C. C. H., Income Tax Service, Section 1150 E. 92; Section 338.04; Section 338.42.

[8] Section 165 (a), I. R. C.

the Commissioner not to be discriminatory" in favor of officers, stockholders, supervisors and high-priced employees. Few lawyers will have the nerve of installing a pension trust without asking the Commissioner's prior approval, though the law does not generally require it. Qualifying the eligibility schedule therefore is no additional burden, and such qualification often is obtained for a plan not even close to the percentages in Sec. 165(a) (3) (A), I. R. C.

(dd) The plan must not discriminate in favor of key employees (officers, etc.). This requirement is not the same as that in (cc), above. There the question is eligibility in the abstract. The question here is the actual results in the operation of a plan.

(b) The law expressly states that a plan shall not be considered discriminatory merely because it is limited to, or favors, employees with incomes exceeding those covered by the Federal Insurance Contributions Act, or is limited to salaried or clerical employees, and for other stated reasons.[9] The emphasis here is on the "merely." The Commissioner, in point of fact, does not acknowledge a classification excluding F. I. C. A.-covered incomes as non-discriminatory unless benefits receivable under the plan and under the Federal Social Security program are integrated according to a rather complicated formula.[10] The purpose of the integration formula is to assure that no high-priced employee can receive a greater retirement benefit in the proportion to pay than the excluded employees.

The Commissioner further requires a good reason for limiting a plan to clerical and salaried employees, though the law declares such classification not to be in itself discriminatory. A good reason for such classification usually is recognized where the non-clerical employees are unionized and clerical employees are not.

Regulation 111, Section 29.165-3, adds that classifications according to age, years of service, or departments are not in themselves discriminatory.

(c) A few important developments or considerations in the tax treatment of pension trusts deserve special mention.

(aa) The Commissioner had previously ruled that no plan was acceptable where 30% or more of the employer's contribution benefited employees holding 10% or more, each, of the employer's stock. This ruling greatly reduced the availability of pension plans in closed corporations. In the *Volckening* case [11] the tax court struck that rule down. Under that case, pension plans using even 60% of the contribution for the benefit of large stockholders may therefore now qualify if otherwise non-discriminatory.

(bb) A pension trust may be made revocable at will. But revocation of the trust within a short time after its inception, or after benefits to key employees have been funded will be taken as evidence of lack of a bona fide plan for its inception, unless

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[9] Section 165(a)(5).

[10] Reg. 111, Section 29.165-3; Minn. 5539; Section 1150 E. 46, C. C. H.

[11] 13 T. C. 94; C. C. H. Dec. 17, 277.

business necessity causes the termination.[12] But the Tax Court has held that if there is *any* good reason, the plan may be abandoned without tax penalty, even after only one year of operation.[13]

(cc) Perhaps the most important single element in pension trust militating against their wider use by business is the necessity of regular, predetermined contributions, regardless of profits made, and even if a loss is incurred. The risk therein is partly eliminated through the carryback and carryover provisions of Section 122, I. R. C., which put every business on a long range business cycle, permitting, to some extent, the equalization of losses in one year against profit in others. But this is hardly sufficient to reassure the cautious businessman. Attempts have therefore been made to devise plans which would require contributions in good years only. Many lawyers, including this writer, combined a pension with a profit sharing trust. Contributions to a profit sharing trust need be made from profits only. The profit sharing trust then provided that in years without profit the contribution to the pension trust may be made by the profit sharing trust, instead of by the employer.

The Commissioner early disturbed these dreams, by ruling against such "feeder" arrangements.[14] As amended, this P. S. 37, now contains the following additional provision:

> In certain cases, however, in which employees have non-forfeitable rights, they may designate the use of . . . profit sharing funds, for their individual use, to meet the cost of a pension plan that is also operated for their benefit.

In a letter-ruling to this writer of July 21, 1952, E. I. McLarney, Deputy Commissioner, states that this clause does *not* permit a feeder-arrangement. Pressed further, Norman A. Sugarman, Assistant Commissioner, on August 29, 1952, in a letter-ruling to this writer elaborated as follows:

> Where a profit-sharing plan provides that a participant may request the use of the funds allocated to his account (to the extent vested in him) for the payment of premiums on a contract purchased by a pension trust to provide retirement income for him in the event the employer shall fail to make contributions to such pension trust, such provision will not, of itself, cause the profit-sharing trust to fail of exemption under section 165 (a) of the Code.
>
> The above examples differ from the situation discussed in your letter of June 26, 1952 and office reply thereto of July 21, 1952. In your letter of June 26, 1952, you quoted a proposed provision that would automatically bear the employer's commitment under the pension plan in any year its profits were insufficient to pay the cost

[12] Reg. 111, Section 29.165-1.
[13] Blume Knitwear, 9 T. C. 1177.
[14] P. S. 37.

of such pension plan. The use of the funds of a profit-sharing plan in the manner described in the second and third paragraphs of this letter contemplate the use of funds at the disposal of the participant and not as a part of the funding of the employer's commitment under its pension plan. A pension trust will not meet the qualification for exemption under Code section 165 (a) and section 29.165-1 (a) of Regulations 111, where funding of benefits provided under the plan depend upon the presence of annual profits.

It would seem that on the basis of this ruling, a clause in a profit sharing trust, specifically agreed to be a participant, is unobjectionable if the clause authorizes the trustee to pay from the participant's share in the profit sharing fund to the Pension Trust that part of the pension trust contribution which is allocable to the particular participant, in any year when the employer fails to make his contribution to the pension trust. If this is so, then the stress on the employer in a lean year is at least alleviated. Nonpayment by the employer of the contribution to the Pension Trust for valid reasons will not, ordinarily, disqualify the Pension Trust; and the participant will be glad to authorize payment of the pension contribution allocable to him from his share in the profit sharing fund, in order to protect the participant's investment in the Pension Trust. The part of a pension contribution which is allocable to a specific participant is easily determined in the frequent situation where the pension plan is funded by the purchase of annuities, often combined with life insurance proportionate to the annuity, for each individual participant. The allocable part of the total contribution then simply is the premium charged by the insurance company for the annuity-part of the policy for this particular participant.

(dd) An almost "discretionary" pension arrangement, leaving the selection of participating employees, and amount and time of contributions entirely up to the employer, seems to be possible under the recent *T. J. Moss Tie Company* case.[15] There a corporate employer set up a trust for the purpose of assisting employees, and in the discretion of the trustees distributions could be made in case of retirement. The court held the trust a "charity" under Section 101 (8), I. R. C., and contributions thereto deductible as charitable contributions. This arrangement permits timing of the contributions in years with high profits. Since no immediate benefits accrue to any individual employee, no income tax liability of any employee would seem to arise at the time of the contribution, and no stabilization problem would seem to occur until payment to the employee. The Moss arrangement may solve the problem of employers who "want to do something" for their employees without tying themselves down to the somewhat rigid pattern of a pension plan under Section 165(a), I. R. C.

[15] 18 T. C. 25; Comm. I. R. announced Nonacquiessence, Int. Rev. Bul. No. 20, Sept. 20, 1952, released since this article was written.