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Employees' Benefit Plans

By Edwin M. Sieradz*

Pension and other employees' benefit plans are nothing new to the American scene. Progressive employers have long found it wise to solve the business's superannuation problem, and to tie their employees closer to the organization, by providing means by which deserving long-term employees may receive regular payment, after retirement, usually beginning at the age of sixty-five or under, for the rest of their lives, and under which such employees would somehow share in the business' profits. Such payments, together with expected social security (old age), and private insurance benefits, might well assure a comfortable old age to a man who otherwise might not be able to accumulate more than necessary to just "get along."[1]

Such plans were, however, on the whole confined to large business enterprises because the problems above referred to were and are more burdensome there than in small and medium sized organizations. It is therefore of interest to note that at present an increasing number of such smaller enterprises have become interested in pension and other employees' benefit plans.

The reason is that there are now more businesses making fair profits than ever before; that the Revenue Act of 1942[2] introduced or clarified certain tax advantages to be gained from qualified plans; and that qualified plans are not violative of the wage stabilization law. A trust which meets with the requirements of the revenue act is tax exempt, the employer's contribution to a qualified plan is a deductible expense, and no taxable income accrues to the employee from such a plan until benefits are actually received. Although payments to a pension trust amount in effect to postponed salary payments, they are not within the prohibitions of the wage and salary freezing orders.

A plan may be so organized as to require the interposition of a trust. It may, on the other hand, be so arranged as to dispense with a

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[1]Interesting material relative to the foregoing may be found in Sen. Rep. 610, 76th Congress, at 64.

[2]Public Law 753, 77th Congress, second session, approved October 21, 1942.

trust agreement, for example by direct purchase of annuities from an insurance company.[3] However a benefit plan be organized, it requires a "lawyer's touch." The following pages are intended to give a survey, and not more than that, of the law involved.

I.

A short summary of the tax situation of employees' benefit plans prior to the Revenue Act of 1942 is in order for two reasons:

First, the 1942 act is remedial in scope[4] and is designed to avoid the tax avoidance possibilities of the old law. Under established rules of interpretation, a remedial law should, if possible, be so construed as to remedy the abuses against which it is directed.[5]

Secondly, the new Section 165 I. R. C. dealing with the tax exemption of employees' pension trusts and similar plans, and the new Section 23 (p) I. R. C. dealing with the deductibility of employer contributions to such plans, will not go into effect as to plans existing on or before September 1, 1942, until the first taxable year beginning after December 31, 1942.[6] Until then, therefore, the old law applies.

The law on this subject, prior to the Revenue Act of 1942, has been thus summarized:[7]

(1) Key men trusts are condemned by the Commissioner, approved by the Board, and tolerated by Congress through disregard after the problem was submitted to it.

(2) The fact that the trust does not qualify under Section 165 does not deprive the employer of right of deduction for amounts paid into it if the amounts qualify as reasonable compensation.

(3) If the trust does not qualify under Section 165, the right to deduct lump sum payments over a 10-year period is denied.

(4) Even though the trust does not qualify under Section 165, the amounts paid in by the employer are not income to the employee when paid in.

(5) Even though the trust does not qualify under Section 165, it is not taxable on the amounts paid in by the employer or employee, but failure to qualify deprives it of its right to exemptions as to other income received by it.

Under the new law, as under the old one, three questions must be distinguished:

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[3]As to contracts combining annuities with life insurance features see *infra*, part II, second paragraph.

[4]See R. E. Paul's statement before the House Ways and Means Committee, H. R. Hearings, Revenue Revision, 1942, Vol. I 87, 1004 and 5, and Vol. III 2405, ff.

[5]See 59 C. J. 2405, ff.

[6]S. 162 (d) of the 1942 revenue act.

[7]*Washington Tax Talk* (1942) 20 TAX MAGAZINE 432, at 435.

(1) When is a trust forming a part of an employees' benefit plan tax-exempt?[8]

(2) When are employer contributions to such trusts or other employees' benefit plans deductible expenses to the employer?[9]

(3) When are the employer's contributions to an employee benefit plan taxable income to the employee?[10]

1. A trust forming part of a stock bonus, pension, or profit-sharing plan is, according to Section 165 (a) I. R. C. tax-exempt under the following conditions:

(a) At least seventy per cent of all permanent employees must be eligible to participate in the plan, and at least fifty-six per cent of all permanent employees must actually participate.

Permanent employees are those who have been employed by the present employer for more than a minimum period set up in the plan (not in excess of five years), who are customarily employed for more than twenty hours in any one week, and who are employed more than five months in any calendar year.[11]

(b) When the plan does not meet these requirements it may still qualify if the classification of benefits is found by the Commissioner of Internal Revenue not to be discriminatory in favor of stockholders, officers or supervising employees.[12]

(c) The principal and income of the trust must be solely for the benefit of the employees, and it must be legally impossible to use the fund for any other purpose as long as there are liabilities due employees under the plan.[13]

In Section 165 (a) (5) I. R. C. it is expressly stated that a plan shall not be discriminatory merely because it excludes employees whose total wages or salaries are $3,000 or less.[14] Certain other limitations of a plan are also said not to be necessarily discriminatory.[15] Since in an average business few employees other than "key-men" will earn more

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[8]Dealt with in S. 165 (a) I. R. C.

[9]Dealt with in S. 23 (p) I. R. C.

[10]Dealt with in S. 165 (b), (c) and S. 22 (b) (2) (B) I. R. C.

[11]S. 165 (a) 3A I. R. C. Persons who do not meet these conditions, though actually employed, are not considered "employees" for the purpose of computing participation requirements under the act. Reg. 103, S. 19; S. 165 (a) (3)-1 I. R. C.

[12]S. 165 (a) (3) (B) I. R. C.

[13]S. 165 (a) (2) I. R. C. The trust instrument must affirmatively make it impossible for the non-exempt diversion of the fund to occur, but the settlor need not relinquish *all* power over the trust. Reg. 103, S. 19: S. 165 (a) (2)-1 I. R. C.

[14]See SS. 165 (a) 5 and 1426 (a) (1) I. R. C.

[15]*e. g.* Limitation to salaried and clerical employees S. 165 (a) (5) I. R. C.

than $3,000 a year, it may be doubted whether the purpose of the 1942 revenue act to remove discrimination will be achieved to this extent.[16]

2. The deductibility of employer contributions to employees' benefit plans was formerly determined by Section 23 (a) I. R. C., relating to business expense, and Section 23 (p). Under the new Section 23 (p) (1) I. R. C. the deductibility of employer contributions to such plans is governed by Section 23 (p) I. R. C. to the extent that such contributions are "reasonable" under Section 23 (a) I. R. C.[17]

Two situations must here be distinguished: Contributions to plans meeting with the requirements of Section 165 (a) I. R. C. as to non-discrimination and coverage and contributions to plans not so qualified.

(a) Employer contributions to a plan qualified under Section 165 (a) I. R. C. are deductible under Section 23 (p) I. R. C. if they meet with the following requirements:

(A) As a rule, employer contributions to a plan may not exceed five per cent of the aggregate payroll of participating employees during a taxable year.

(B) Employer contributions in excess of five per cent of the aggregate payroll may be allowed when

(aa) both past and current service credits are determined in terms of a level amount at retirement age, or in terms of a level percentage of average income prior to retirement,[18] or

(bb) when an employer contributes an amount equal to the "normal cost of the plan" as determined by the Commissioner, plus, if past service credits are provided by the plan, an amount not in excess of ten per cent of the cost which would be required to completely fund such past service credits as of the date they are included in the plan.[19]

These exceptions sound more complicated than they really are. For the first one (level amount, or level percentage) I shall give the example set out in the Senate Finance Committee report on the 1942 tax bill:

> The actuary may determine, on the basis of a study of all relevant data * * * that if the employer contributes yearly 4% of the total compensation of the employees for current service credits and 3% for past service credits, making a total of 7%, the trust may be expected to have sufficient funds to pay all the pensions

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[16]Reg. 103, S. 19; S. 165 (a) (3)-1 I. R. C. enunciates, however, a "theory of integration" which requires that total benefits resulting to each employee under the plan and under the Social Security Act be reasonably correlated.

[17]Reg. 103, S. 19.23 (p) (1)-1.

[18]S. 23 (p) 1 (A) I. R. C.

[19]S. 23 (p) (1) (a) (iii) I. R. C.

provided by the plan. * * * The Committee feels that for such cases the employer's contributions are a proper deduction, even if in excess of 5%.

Under the second exception, the "normal cost of the plan" is the amount which it would cost to buy annuities in such amounts as are earned by the employees by that particular year's service. And the additional ten per cent of cost to "fund past service credits" is simply ten per cent of the "single premium" which an insurance company would charge to guarantee the payment of such annuities as are provided under the plan for services rendered prior to the time the plan goes into effect.[20]

Section 23 (p) (1) (A) (4) is new. This section allows the employer to carry over contributions made in excess of the foregoing limitations to succeeding taxable years in which contributions do not reach the maximum amount allowed.

(b) If the plan does not qualify under Section 165 (a) I. R. C., then the employer may deduct contributions to it only if the employees' rights to, or derived from the employer's contributions are "non-forfeitable."[21]

Under what circumstances employees' benefits are "non-forfeitable" within the meaning of the act is not entirely clear. Definitions of the term, as used in statutes requiring certain non-forfeitable benefits in life insurance policies, are not of great help. They define the word as meaning "not subject to forfeiture," which is about what one would have expected.[22]

The term must be interpreted by correlating Section 23 (p) with Section 165 (c) I. R. C., which declares an employer's contributions to non-qualified plans to be income to the employee only if his rights are non-forfeitable. Since the minimum right of an employee under such a plan must be to payments beginning at a certain age, the employee's right would seem to be "forfeitable" if this can be taken away from him. But it would not be forfeitable only because the employee's rights terminate prior to the age of retirement provided in the plan.[23]

3. The income tax situation of an employee participating in an employees' benefit plan is as follows:

(a) Where the plan qualifies under Section 165 (a), there the contribution of the employer is not considered as additional income to the employee at the time the contribution is made.[24]

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[20]Reg. 103, S. 19.23 (p) (1) (A)-4.

[21]S. 23 (p) (1) (D) I. R. C.

[22]See Adams v. Ohio Nat. Life Ins. Co., 231 Mo. App. 881, 105 S. W. 2d 64 (1937).

[23]Reg. 103, S. 19.165 (c)-1.

[24]For one exception, see *infra*, part II, second paragraph.

If a participating employee leaves the employer, withdraws from the plan and receives a cash payment before retirement age, the amount he receives in excess of the total amount of the *employee's* contribution (if any) is reportable as *capital gain* from assets held for more than six months, which makes the gain fifty per cent taxable.

When the employee attains retirement age and pension benefits are paid, the amounts received are reportable by the employee as if the benefits were paid under an annuity contract, the consideration for the benefits being the amount (if any) contributed by the employee. If the employee did not contribute to the plan, the entire amount of income received is to be included in his gross income. If the employee did contribute to the plan, then three per cent of the total amount of *his* contribution is to be included in his gross income. The balance is exempt until the exempt amounts equal the total amount the employee contributed to the plan. From then on the entire amount received is to be reported as gross income.[25]

(b) Where the plan does not qualify under Section 165 (a) I. R. C. the employer's contributions are considered income to the employee when made, but only if the employee's rights under the plan are non-forfeitable. As to the meaning of "non-forfeitability" the same uncertainty heretofore mentioned prevails.

Employees' benefit plans follow essentially identical rules, whether a pension or profit-sharing plan is in question.[26] The following additional rules, however, apply with regard to bonus and profit sharing, and "combination" plans:

An employer may contribute up to fifteen per cent of the aggregate payroll of participating employees during a taxable year under a bonus and profit-sharing plan. Employer contributions in excess of fifteen per cent may be deductible in any subsequent year if over-payment contributions are offset by reduced employer contributions in such subsequent years.[27]

When a bonus or profit-sharing plan is combined with a pension plan, the employer may contribute up to twenty-five per cent of the aggregate payroll of participating employees during a taxable year.

II.

Sections 165 and 23 (p) I. R. C. deal with the tax situation of pension, bonus, profit sharing, and similar plans only. They do not affect the question of deductibility of premiums paid by an employer on *life insurance contracts* on the lives of employees. In this respect the law

[25] S. 165 (b) with S. 22 (b) (2) (B) I. R. C.

[26] S. 23 (p) (1) I. R. C.

[27] S. 23 (p) (1) (C) I. R. C.

has not changed. Such premiums can, therefore, be deducted by the employer as business expenses if they are in the nature of additional compensation, if the total amount of compensation is not unreasonable, and if the employer is not the beneficiary under the policy. But the premium paid by the employer is, in marked distinction to employer contributions to qualified benefit plans as heretofore discussed, taxable income to the employee.[28]

Under a pension plan, contracts combining retirement income benefits with life insurance protection may be provided for the employees. For such a situation it is now provided that so much of the premium as is, according to actuarial computation, paid for the life insurance protection will constitute income to the employee.[29]

Employer contributions to group insurance plans, too, are deductible business expenses, but do not constitute taxable income to the employee.[30]

III.

Employee benefit plans, as herein outlined, must furthermore heed the wage and salary stabilization law. A short survey of these rules, as affecting employee benefit plans, follows.

Employer contributions to pension plans qualifying under Section 165 (a) I. R. C. are not considered unauthorized wage or salary increases.[31] It follows that employer contributions to pension and other plans not qualifying under Section 165, *supra*, are unauthorized wage or salary increases so long as not approved by the War Labor Board or the Commissioner of Internal Revenue, Stabilization Unit.[32] Payments by the employer of premiums on regular life insurance contracts "on the life"[33] of an employee are not considered unauthorized salary or wage increases where the amount paid is deductible business expense under Section 23 (a) I. R. C. and does not exceed five per cent of the employee's salary, excluding the premium payments.[34]

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[28]S. 24 (a) (4) I. R. C.; Reg. 103, S. 19.24-3; Adams v. Commissioner, 18 B. T. A. 381 (1929); Danforth v. Commissioner, 18 B. T. A. 1221 (1930).

[29]Reg. 103, S. 19; S. 165 (b)-1 I. R. C.

[30]Reg. 103, S. 19.22 (a)-3.

[31]Wage Stabilization Order, Oct. 3, 1942, Title VI, S. 2; Regulation of the Director of Economic Stabilization, Wages and Salaries, S. 4001, 1 (h) (1).

[32]Payments into profit-sharing funds may be salary or wage increases and, if so, require approval by the stabilization agencies. See ALEXANDER TAX NEWS LETTER, Aug. 13, 1943, P. 3209.

[33]This, according to an unpublished letter of A. D. Burford, Deputy Commissioner of Internal Revenue, Salary Stabilization Unit, refers to whole life policies only, not to endowment contracts. Employer contributions to the latter require prior approval of the stabilization agencies.

[34]See Regulation of the Director of Economic Stabilization, Wages and Salaries, S. 4001.1 (h) (2).

If there is any doubt whether the plan is authorized by these regulations or whether approval is necessary, a ruling may be obtained from the War Labor Board or the Commissioner of Internal Revenue, Stabilization Unit, by completing and filing forms NWLB-10 and SSUI, respectively. The War Labor Board has jurisdiction with regard to all wages and salaries below $5,000, the Commissioner of Internal Revenue as to all salaries above $5,000.[35]

IV.

Where the employer is a corporation two more sets of rules have to be observed to make an employee benefit plan safe. I shall deal very cursorily with both as the law has not been changed recently, and as a detailed account of either would require a full-length article.

Some plans of this kind may come within the jurisdiction of the Securities and Exchange Commission.[36] The possibility that corporate minorities might object to a pension or other employee benefit plan must be considered. A single stockholder has a basis for complaint if the payments under the plan amount to waste of corporate assets.[37]

In closing, I wish to refer to a few agreements which may aid the attorney in drafting an employees' benefit plan:

The Socony-Vacuum Oil Company retirement plan, in Senate Report 610, Seventy-sixth Congress, 193.

The Eastman-Kodak "combination" plan, *ibid.*, 182.

A number of plans may be found in the mimeographed "Symposium on Pension and Profit Sharing Funds and Trusts," issued by the Chicago Bar Association, 29 South La Salle St., Chicago, Illinois.

[35] See *ibid.*, SS. 4001.2 and 4001.4.

[36] Compare S. 2 (1) with S. 3 (8) of the Securities Act of 1933.

[37] See Dix, Retirement Allowance and Pension Plans of Private Corporations, 31 GEO. LAW J. 22 (1942).

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