

AN INTRODUCTION TO DEFERRED COMPENSATION ARRANGEMENTS

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INTRODUCTION

This article is designed to generally acquaint the reader with some of the problems in connection with the federal income tax treatment of deferred compensation arrangements. It does not, however, treat the topic in great detail. At the time of the writing of this article, Congress is considering proposals for substantial revisions in this area. Some of the more important changes are discussed in Section III-New Legislation† of this article.

How does the attorney convince or at least illustrate to a corporate client the tax benefits of a qualified deferred compensation arrangement? A good starting point may be to explain exactly what is meant by deferred compensation. Generally, deferred compensation means a plan calling for payments by an employer to a funding medium, such as a trust, which will provide a stream of income to the employee at some point in the future, usually geared towards retirement. A qualified plan is one which meets the requirements of section 401(a) of the Internal Revenue Code of 1954 and thereby qualifies for special tax treatment. One of the principal tax advantages is that a shareholder-employee can include himself in such a plan.¹

At this point, it may still be unclear how a shareholder-employee can benefit by the creation of a qualified plan. Assume that a corporation with only one shareholder who is also an employee has income for the taxable year of \$100,000, before the shareholder-employee receives any salary and after the payment of wages and salaries for all other employees. There would appear to be three ways in which the corporation could make a distribution of the income to the shareholder-employee.²

First, the corporation could make *no* salary payments to him in which case it would pay an income tax at the corporate level on the full \$100,000.

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† [Editors Note. This legislation became law when signed by President Gerald Ford, September 2, 1974.]

1. All section references are to the INTERNAL REVENUE CODE of 1954 unless otherwise noted. [Hereinafter "CODE"]

2. Rev. Rul. 421 Part 2(j)(3), 1969-2 CUM. BULL. 59. All of the benefits which inure from the establishment of a qualified plan will be treated later in the article but we will mention some of them here: (1) Deduction for employer contributions to the plan; (2) Exemption of the trust from taxation on its income; and (3) The participants under a plan are not taxed until the receipt of a distribution from the plan.

Applying the normal corporate tax rate,³ the corporation would be left with \$58,500 to distribute as a dividend to the shareholder-employee. Assuming the shareholder-employee was taxed at the 50% rate, on receipt of the \$58,500 dividend he would be left with a disposable income of \$29,250 or a net after tax cash flow of \$29,250 from \$100,000 of income generated by the corporation.

Second, the corporation could distribute the \$100,000 to the shareholder-employee as a salary. Assuming the salary was not unreasonable, the corporation would get a salary deduction pursuant to section 162(a)(1), leaving the corporation with no taxable income. If the owner-employee were in the 50% bracket, he would have \$50,000 of disposable income, or a net after tax cash flow from the corporation of \$50,000, \$20,750 more than the amount of cash he would have if he had received no salary, only dividends.

Finally, assume that the corporation established a deferred compensation plan which qualified under section 401(a). If the shareholder-employee was paid a salary of \$50,000, and the remaining \$50,000 of corporate income was contributed to a qualified section 401(a) plan on his behalf, the following results would obtain. The corporation could deduct the \$50,000 salary pursuant to section 162(a)(1) and the \$50,000 contribution pursuant to section 404(a); it would, therefore, have no taxable income. The 404(a) deduction is subject to limitations discussed later in the article. The income earned by the \$50,000 contributed in his behalf, would not be subject to taxation because of a special exemption under section 501(a). The result to the shareholder-employee, in the third example can be summarized as follows:

- (1) He receives a \$50,000 salary on which he pays a \$25,000 income tax leaving him with a \$25,000 after tax cash flow.
- (2) All contributions, subject to certain amount limitations, made by the corporation pursuant to the plan would be deductible for tax purposes just as normal employee wages are deductible.⁴
- (3) He would not be required to include in his gross income the amount of the contribution which is allocable to him until he receives it, which normally will be on retirement.⁵ This is an exception to the general rule of taxation that all income earned shall be taxable to the person who earns it, notwithstanding the fact that payment is made to a third party.⁶
- (4) The income earned on such contributions by the funding medium would be exempt from taxation.⁷

An employee normally will be in a lower tax bracket when he begins to receive the distributions from a plan. At such time he may be eligible

3. CODE § 11.

4. See CODE § 404(a).

5. See CODE § 402; 403 and 72 (dealing with employee annuities). But see CODE § 101(b) for \$5,000 exclusion from gross income of amounts received by the beneficiary or the estate of an employee and CODE § 2039(c) for exclusion of the value of an annuity or other payment, received by a beneficiary (other than an executor) from a qualified employee plan, from the gross estate of the decedent.

6. CODE § 61 (defining gross income).

7. CODE § 501(a). See § 503 for requirements for exemption.

for retirement income credit⁸ which may result in none of the distribution being subject to income tax. If his total distribution is paid to him or his beneficiary within one year of his separation from service or on account of his death, it will generally be subject to 7 year averaging treatment, for benefits attributable to employer contributions beginning after 12-31-69. Lump sum distributions attributable to employer contributions prior to 1-1-70 would be afforded long term capital gain treatment.⁹

The cost of a plan is certainly a consideration, but one which the corporation should consider as it would any other operating expenditure. Here the attempt is to merely point out what tax advantages can accrue if a corporation should decide to set up a plan. Aside from the tremendous advantage that can be enjoyed from a tax standpoint, there are certain fringe benefits which may be obtained. For instance, many corporations have experienced a stabilization of their work force and greater productivity which may be, in and of itself, a sufficient justification for establishing a plan.

Although the shareholder-employee may be included in a qualified plan, there are certain restrictions which prevent the use of plans to discriminate in favor of such shareholders.¹⁰

The basic rules under section 401(a) applicable to a plan established by a corporation also apply to a plan established by a partnership, sole proprietor, or Subchapter S corporation,¹¹ which, in general, is treated as a partnership for tax purposes.¹² The major difference in treatment is that a lower ceiling is placed on the maximum contribution and deduction which can accrue for the benefit of a partner, sole proprietor, or shareholder-employee of a Subchapter S corporation.¹³

If a contribution is made for the benefit of a partner, sole proprietor, or shareholder-employee of a Subchapter S corporation, the amount that could be contributed and deducted pursuant to a qualified plan would be limited to an amount equal to 10 percent of earned income or \$2500, whichever is smaller.¹⁴ If the salary of such an owner-employee was \$45,000, only \$2500 could be contributed on his behalf, even if all other employees were receiving 10 percent of their current wages as benefits under the plan. There is at the time of the writing of this article a proposal in Congress to increase the maximum amount of such contribution to 15 percent of earned income or \$7500 whichever is lesser.¹⁵

The counterpart and often a supplement to a qualified plan is a non-

8. CODE § 37.

9. CODE § 72(n).

10. See CODE § 401(a)(3)(B) and 401(a)(4).

11. See CODE § 401(a)(9) and (10); also CODE §§ 401(c) through (e).

12. Subchapter S corporations are defined in CODE § 1371 and their activity is covered by CODE §§ 1372 through 1379.

13. That ceiling being a \$2500 maximum deductible contribution for the benefit of any owner-employee. See CODE § 401(e)(1)(B) for partnerships and sole proprietors and CODE § 1379 for Subchapter S corporations. See also CODE § 401(e)(2) and (3) for special rules regarding excess contributions on behalf of owner-employees.

14. CODE § 401(e)(1)(B) and CODE § 1379.

15. See H.R. Res. 2, 93rd Cong., 1st Sess. CODE § 2001 (1974), and S. Res. 4200, 92d Cong., 2d Sess. CODE § 704 (1973).

qualified plan, where the employer chooses for a number of reasons not to qualify the plan. First, the non-qualified plan is highly flexible and it may discriminate in favor of shareholder-employees. Further, such plans are not bound by the rules which limit contributions under qualified plans.¹⁶ However, they suffer a number of tax disadvantages. The employer is not allowed a tax deduction for his contributions until the employee includes in his gross income the amount attributable to such contribution.¹⁷ Also, if the plan uses a trust as a funding medium the income received by the trust will not be exempt from taxation. Separate accounts must be maintained if more than one employee participates.¹⁸ In a situation where costs are of crucial concern to the employer, the costs of a qualified plan due to certain requirements as to who must be included under the plan may be prohibitive. In such case the employer may use a non-qualified plan and include only those employees whom he can afford.

Section 401(a) refers to three types of employee qualified plans: pension, profit-sharing, and stock bonus. This article will not treat stock bonus plans, however, such plans generally follow the requirements for pension and profit-sharing plans.¹⁹ The regulations define a pension plan as:²⁰

[A] plan established and maintained by an employer to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. . . . The determination of the amount of retirement benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of service, or other reason, may be used to provide increased benefits for the remaining participants.

A pension plan may not, however, provide for the payment of benefits for health, accident, hospitalization, or medical expenses except in the case of retired employees.²¹ A pension plan may be a defined benefit plan or a defined contribution plan. A defined benefit plan is one in which contributions are determined actuarially by reference to definitely determinable benefits such as percentage of salary. A defined contribution plan is one in which a fixed amount is contributed annually. Since, the defined contribution plan is not geared towards providing any specific benefit, the costs (e.g. the amount of the contribution) are determined by the employer. The contribution selected becomes a fixed annual premium over the life of the pension plan.

The regulations define a profit-sharing plan as:²²

[A] plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of

16. CODE § 404(a)(5) does not place a limit on the deduction but it stands to reason that it must survive the CODE § 162(a)(1) scrutiny for reasonableness.

17. CODE § 404(a)(5).

18. *Id.*

19. See Treas. Reg. § 1.401-1(b)(iii) (1972) for definition of stock bonus plan.

20. Treas. Reg. § 1.401-1(b)(1)(i) (1972).

21. *Id.*

22. Treas. Reg. § 1.401-1(b)(1)(ii) (1972).

years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

It is primarily a plan of deferred compensation, but may provide for, *inter alia*, incidental life, accident or health insurance.²³

A further distinction between pension and profit-sharing plans is the limitation on the deduction an employer may take for his contributions to the plan. With a pension plan the deduction is generally limited to 5 percent of covered compensation paid or accrued to those under the plan, subject to exceptions to be considered below.²⁴ The deduction for contributions to profit-sharing plans is limited to 15 percent of covered compensation of eligible employees paid or accrued during the taxable year.²⁵ Under both plans there are provisions for a carryover to future years of excess contributions.²⁶

The question of what type of plan may be best suited in a particular case is really a matter of what the employer is attempting to achieve. The inquiry should consider the relative ages of those to benefit under the plan as well as the general business conditions of the employer.

I. SECTION 401(a) QUALIFIED PLANS

Generally, there are two funding mediums for a qualified plan. One is a trust under which an employer's contributions are managed by one or more trustees. The other is a commercial institution to which the employer's contributions are paid for the purchase of employee annuities. In either case the plan must conform to the requirements set out in section 401(a) and the multitude of revenue rulings, regulations, and cases that interpret that section.

As indicated in the introduction there are several good reasons for qualifying a plan. First, an employer may deduct his contributions to the plan in the current tax year subject to the limitations under section 404(a). Second, the income of a trust under a plan is exempt from taxation under section 501(a) unless the trust engages in certain prohibited transactions.²⁷ Third, the employee does not include any part of the employer's contribution in gross income until he receives a distribution from the plan.²⁸

Treasury regulation section 1.404-1(a)(3)(1972) enumerates nine requirements which a trust forming part of a pension or profit-sharing plan must meet:

- (i) It must be created or organized in the United States, as defined in section 7701(a)(9), and it must be maintained at all times a domestic trust in the United States;

23. *Id.*

24. See CODE § 404(a)(1).

25. See CODE § 404(a)(3).

26. See CODE § 404(a)(1)(D) for carryover of contributions to pension plans, and CODE § 404(a)(3)(A) for carryover of contributions to profit-sharing plans.

27. See CODE § 503(a)(1)(B) for denial of exemption and CODE § 503(b) where prohibited transactions are defined. See also CODE §§ 511 through 514 dealing with taxation of unrelated business income.

28. See generally CODE § 402.

- (ii) It must be part of a pension, profit-sharing, or stock bonus plan established by an employer for the exclusive benefit of his employees or their beneficiaries . . . ;
- (iii) It must be formed or availed of for the purpose of distributing to the employees or their beneficiaries their corpus and income of the fund accumulated by the trust in accordance with the plan, and, in the case of a plan which covers . . . any self-employed individual, the time and method of such distribution must satisfy the requirements of section 401(a)(9) with respect to each employee covered by the plan. . . ;
- (iv) It must be impossible under the trust instrument at any time before the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries. . . ;
- (v) It must be part of a plan which benefits prescribed percentages of the employees, or which benefits such employees as qualify under a classification set up by the employer and found by the Commissioner not to be discriminatory in favor of certain specified classes of employees. . . ;
- (vi) It must be part of a plan under which contributions or benefits do not discriminate in favor of certain specified classes of employees . . . ;
- (vii) It must be part of a plan which provides the nonforfeitable rights described in section 401(a)(73). . . ;
- (viii) If the trust forms part of a pension plan, the plan must provide that forfeitures must not be applied to increase the benefits any employee would receive under such plan. . . ;
- (ix) It must, if the plan benefits any self-employed individual who is an owner-employee, satisfy the additional requirements for qualification contained in section 402(a)(10) and (d).

The overriding requirements is that the trust be formed for the exclusive benefit of the employees or their beneficiaries.²⁹ The trust must be valid under local law³⁰ and will not fail for the lack of a corpus on the last day of the taxable year, if the employer pays the required corpus by the 15th day of the 3rd month following the close of the taxable year.³¹ It is not essential that the employer release all rights to modify or terminate the trust, but it must be impossible for the trust funds to be diverted.³² The trust may be funded solely by employer or employee contributions, or a combination of the two.³³

29. CODE § 401(a).

30. The trust must be written and not oral, see Rev. Rul. 231, 1969-1 CUM. BULL. 118. Enforcement of the trust instrument is also a matter of local law but the Internal Revenue Service will reexamine the plan if distributions do not follow the plan. See Rev. Rul. 570, 1969-2 CUM. BULL. 91, and Rev. Rul. 315, 1970-1 CUM. BULL. 91, *modifying* Rev. Rul. 297, 1955-1 CUM. BULL. 393.

31. Rev. Rul. 421 Part 3(a), 1969-2 CUM. BULL. 59, and Rev. Rul. 419, 1957-2 CUM. BULL. 264.

32. Treas. Reg. § 1.401-2(b)(2) (1964).

33. It is not sufficient that the employer merely acquiesce in the unilateral action of his employees, the plan must be established and maintained by him even though funded solely by employee contributions. Rev. Rul. 205, 1966-2 CUM. BULL. 119; Rev. Rul. 152, 1954-1 CUM. BULL. 149; *Times Publishing Co. v. Commissioner*, 184 F.2d 376 (3rd Cir. 1950) *aff'g* 13 T.C. 329 (1949).

The employer may not recover from a trust any excess contributions,³⁴ though he may take a deduction in future years for such excess payments.³⁵ There are three exceptions to this general prohibition. The first is where the excess payment is due to an error in the actuarial computation. In this situation the employer may reserve the right to recover the surplus remaining after the termination of the trust and satisfaction of all obligations.³⁶ It is important to note that this exception does not apply to the profit-sharing plan as it does not provide for definitely determinable benefits.³⁷ Second, the trust may contain a provision for return of contribution in the event the plan fails to receive a letter of approval from the Service.³⁸ Finally, the trust may contain a spendthrift provision which prohibits any creditor, other than the employer, from reaching the trust corpus.³⁹

Section 401(a)(3) and (4) set up requirements with respect to the number of employees who must be covered by a plan. Clause (A) of section 401(a)(3) provides a "percentage test." Clause (B) of section 401(a)(3) and section 401(a)(4) provide discrimination tests.⁴⁰

The percentage test involves a simple mathematical calculation which turns on the number of employees who are eligible to participate under the plan. The applicable percentage is:⁴¹

70 percent or more of all employees, or 80 percent or more of all employees who are eligible to benefit under the plan if 70 percent or more of all the employees are eligible to benefit under the plan,

In determining whether the test has been met it must first be determined against what total number the percentage is to be applied.⁴² For example, assume that an employer has 100 employees. If at least 70 percent are covered by the plan, the test is met. If, on the other hand, 30 employees were not eligible to participate because of limitations in the plan, the total number of eligible employees would be 70. In such case, 70 percent of the total number of employees would be eligible to benefit. Consequently, if 80 percent of the 70 eligible to benefit, or 56, were covered the test would be met. But if fewer than 70 percent were eligible, the test could in no case be met, even if greater than 56 were covered.⁴³

34. Treas. Reg. § 1.401-2(b)(2) (1964).

35. CODE § 404(a)(1)(D); Treas. Reg. § 1.404(a)-7(a) (1961). *But see* Rev. Rul. 193, 1958-1 CUM. BULL. 208, denying a carryover to the estate of a deceased employer.

36. Rev. Rul. 421 Part 3(d), 1969-2 CUM. BULL. 59, and Treas. Reg. § 1.401-2(b)(1) (1964).

37. Rev. Rul. 421 Part 3(e), 1969-2 CUM. BULL. 59, and Treas. Reg. § 1.401-1(b)(1)(ii) (1972). Also, Goodman, *Legislative Development of the Federal Tax Treatment of Pension and Profit-Sharing Plans*, 49 TAXES 226, 229 (1971).

38. Rev. Rul. 421 Part 3(c), 1969-2 CUM. BULL. 59, and Rev. Rul. 276, 1960-2 CUM. BULL. 150.

39. Rev. Rul. 421 Part 3(c), 1969-2 CUM. BULL. 59, and Rev. Rul. 432, 1956-2 CUM. BULL. 284.

40. *But see* Rev. Rul. 421 Part 4(j), 1969-2 CUM. BULL. 59, for plans which are integrated with benefits provided under the Social Security Act.

41. CODE § 401(a)(3)(A).

42. *See* CODE § 401(a)(3)(A) for determination of the group. *See also* Rev. Rul. 2, 1970-1 CUM. BULL. 93, where a plan that excluded uncompensated employees who met the service requirements of the plan and who worked more than 20 hours per week for more than 5 months per year was found not to satisfy CODE § 401(a)(3)(A).

43. *See* example in Treas. Reg. § 1.401-3(a)(3) (1971).

The discrimination test under clause (B) of section 401(a)(3) is designed to prevent the utilization of a plan

. . . for the principal benefit of the shareholders, officers, persons whose principal duties consist in supervising the work of other employees, or highly paid employees, or as a means of tax avoidance. . . .⁴⁴

The regulations further provide that:

[i]f a plan fails to qualify under the percentage test of . . . [clause (A)], it may still qualify under . . . [clause (B)] provided . . . [the plan does not] discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or the highly compensated employees.⁴⁵

Consequently, in the above example where fewer than 70 employees were eligible, the plan may still qualify if it could be established under clause (B) that it did not discriminate. In a case where, although less than 70 were eligible but greater than 56 participated the plan might very well qualify.⁴⁶

Even if the percentage test or discrimination test of section 401(a)(3) is met, there is a second discrimination test in section 401(a)(4) which is designed to prevent discrimination in contributions or benefits.⁴⁷ That section reads as follows:

[I]f the contributions or benefits provided under the plan do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

If a plan does not meet the test under that section it will not be given approval.

Discrimination under both 401(a)(3)(B) and (a)(4) are factual determinations to be made by the Commissioner on a case by case basis.⁴⁸ Section 401(a)(5) provides that certain classifications will not, in and of themselves, be considered discriminatory. The section provides, *inter alia*:

[A] classification shall not be considered discriminatory within 401(a)(3)(B) or (4) merely because it excludes employees whose remuneration constitutes 'wages' . . . or merely because it is limited to salaried or clerical employees. Neither shall a plan be considered discriminatory within the meaning of such provisions merely because the contributions or benefits bear a uniform relationship to the total compensation, of such employees,

44. Treas. Reg. § 1.401-3(a)(1) (1971).

45. Treas. Reg. § 1.401-3(b)(1971).

46. See example in Treas. Reg. § 1.401-3(a)(3) (1971).

47. In pension plans (other than money purchase) benefits can not be discriminatory. In stock bonus, profit-sharing plans, or money purchase pension plans, contributions must not discriminate. See Rev. Rul. 331, 1971-2 CUM. BULL. 205.

48. For instances where factual determinations have been made see: *Container Service Co. v. United States*, 345 F. Supp. 235 (S.D. Ohio 1972); *Greenwald v. Commissioner*, 366 F.2d 538 (2d Cir. 1966); *United States v. Hall*, 398 F.2d 383 (8th Cir. 1968); *Pepsi-Cola Niagara Bottling Corp.*, 48 T.C. 75 (1967); *Loper Sheet Metal, Inc.*, 53 T.C. 385 (1960); Rev. Rul. 12, 1966-1 CUM. BULL. 72; Rev. Rul. 13, 1966-1 CUM. BULL. 73; Rev. Rul. 14, 1966-1 CUM. BULL. 75; Rev. Rul. 15, 1966-1 CUM. BULL. 83; Rev. Rul. 244, 1968-1 CUM. BULL. 158; Rev. Rul. 301, 1968-1 CUM. BULL. 161; Rev. Rul. 144, 1969-1 CUM. BULL. 115; Rev. Rul. 58, 1969-1 CUM. BULL. 127; Rev. Rul. 2, 1970-1 CUM. BULL. 93; Rev. Rul. 200, 1970-1 CUM. BULL. 101.

The key is always the exclusive benefit concept. If the plan discriminates then it is not for the exclusive benefit of the employees.

For the purposes of meeting the coverage provisions under 401(a), an employer may designate several plans or trusts as one plan. In such case, all of the trust and plans taken as a whole may qualify, if the plans designated as one plan cover a sufficient portion of all employees.⁴⁹ If any of the individual plans joined together for qualification discriminate, all the plans may be disqualified.⁵⁰

The exclusive benefit and non-discrimination provisions are also important considerations in determining whether or not a plan is permanent. As expressed in Treasury Regulation 1.401(b)(2)

The term 'plan' implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general.

There are no detailed rules as to the permanency requirement, but consideration of the relevant factors surrounding creation or abandonment may be evidence of the employer's good faith. Factors which may bear upon the question of permanency of the plan include: ability to make future payments, history of earnings, purpose of its creation, and accrued benefits of selected employees as opposed to the rank and file at the time of abandonment.⁵¹

A termination of a plan by an employer may cause a retroactive disqualification. In order to prevent such disqualification the employer must sustain the burden of proof that the termination was a business necessity.⁵² The fact that: (1) a plan is one that has been in existence for many years;⁵³ (2) the benefits are fully vested; and (3) the termination does not result in prohibited discrimination, will tend to indicate that the termination was bona fide.⁵⁴ A termination without business necessity will raise the pre-

49. Rev. Rul. 15, 1966-1 CUM. BULL. 83.

50. Rev. Rul. 421 Part 5(h) and (i), 1969-2 CUM. BULL. 59; Rev. Rul. 304, 1972-1 CUM. BULL. 112.

51. Rev. Rul. 421 Part 4(a), 1969-2 CUM. BULL. 59.

52. Rev. Rul. 183, 1970-1 CUM. BULL. 103.

53. Rev. Rul. 421 Part 2(h), 1969-2 CUM. BULL. 59. If the plan is a profit-sharing plan, single or occasional contributions do not establish a qualified plan. Treas. Reg. § 1.401-1(b) (2) (1972) The contributions must be recurring and substantial, however, it is not necessary that the employer contribute every year or that he contribute the same amount or contribute in accordance with the same ratio each year. See also, *Lincoln Electric Co. Employee's Profit-Sharing Trust v. Commissioner*, 190 F.2d 326 (6th Cir. 1951) *aff'g* 14 T.C. (1950). E.R. *Wagner Mfg. Co.*, 18 T.C. 657 (1952); *Estate of Harold S. Davis*, 22 T.C. 807 (1954).

54. That presumption may be rebutted by showing that the plan qualified theoretically, by its actual operation, or surrounding circumstances indicate that it was intended to be permanent, and current unforeseen business conditions seriously endanger the business if the plan is continued. *Blume Knitwear, Inc.*, 9 T.C. 1179 (1947). *Kane Chevrolet Co., Inc.*, 32 T.C. 596 (1959). The business necessity defense involves a factual determination. It is limited to bankruptcy, insolvency, or discontinuance of business and where adverse business conditions have occurred which were not foreseeable and not within the control of the employer. Plant expansion, pay raises, and good faith change in stock ownership and management have been justified as terminations for business necessity. *Clifford M. Houg*, 54 T.C. 792 (1970). First

sumption that the plan was never intended for the exclusive benefit of the employees.⁵⁵ The effect of a retroactive disqualification may be to disallow the deduction taken by the employer for years in which the plan was determined not to qualify. And in addition, the trust which forms part of a qualified plan may lose its exempt status, retroactively.⁵⁶

Section 401(a)(7) was designed to protect the interests of employees under a plan upon partial or complete termination, or complete discontinuance of contributions. It requires that ". . . the rights accrued to the date of such termination or discontinuance, to the extent then unfunded, or the amounts credited to the employees' accounts are nonforfeitable." The employer may not control the conditions that govern nonforfeitability⁵⁷ and provision must be made for the allocations of previously unallocated funds.⁵⁸ On the termination of a pension plan there need only be an allocation of amounts to satisfy the liabilities with respect to employees and their beneficiaries.

Discontinuance of contributions is in effect a termination and the same requisites that apply to a termination also apply here.⁵⁹ If a trust forms part of a qualified plan which has been terminated, the trustee must keep the trust intact and await the advice of the Internal Revenue Service.⁶⁰ Once the Internal Revenue Service has resolved the issue of whether the plan was a bona fide program for the exclusive benefit of employees, the trustee may then follow the provisions of the trust agreement governing liquidation and distribution.⁶¹

II. EMPLOYER'S DEDUCTIONS FOR CONTRIBUTIONS⁶²

Contributions to an employee benefit plan may be deducted⁶³ under section 404(a) only to the extent that they are otherwise ordinary and necessary expenses for compensation for personal services actually rendered within the meaning of section 162(a).⁶⁴ No deduction will be allowed under section 404(a)⁶⁵ for any contribution which together with the deduction taken for wages and salaries constitutes unreasonable compensation.⁶⁶ What constitutes "reasonable" compensation depends upon the facts and circumstances in the particular case.⁶⁷ Contributions in no case can be de-

National Bank of Birmingham v. Adams, 203 So. 2d 124 (Ala. 1967). Dierks v. Thompson, 414 F.2d 453 (1st Cir. 1969).

55. Rev. Rul. 239, 1972-1 CUM. BULL. 107.

56. Rev. Rul. 24, 1969-1 CUM. BULL. 110; Rev. Rul. 25, 1969-1 CUM. BULL. 113.

57. Rev. Rul. 25, 1969-1 CUM. BULL. 113.

58. Rev. Rul. 181, 1972-1 CUM. BULL. 113.

59. See generally; Rev. Rul. 421 Part 6, 1969-2 CUM. BULL. 59., and Treas. Reg. § 1.401-6 (1963). See also Treas. Reg. § 1.401-4(c) (1963).

60. Rev. Rul. 421 Part 6(d), 1962-2 CUM. BULL. 59.

61. Rev. Rul. 252, 1969-1 CUM. BULL. 128.

62. See Treas. Reg. § 1.404(a)-2 (1972) for information required of employers claiming deductions for years ending before 12/31/71, and Treas. Reg. § 1.404(a)-2A(1972) for years ending on or after 12/31/71.

63. See Hydro Molding Co., 38 T.C. 312 (1962) and John T. Carson Co., 38 T.C. 481 (1962) for timing of contributions.

64. Relating to trade or business expenses.

65. See Treas. Reg. § 1.404(a)-1(a)(2) (1963) for application of CODE § 404(a).

66. Treas. Reg. § 1.404(a)-1(b) (1963).

67. *Id.*

ducted under section 162(a). If they fail under section 404(a) they are not deductible.⁶⁸

Contributions to a plan need not be in cash to be deductible⁶⁹ but the employer may suffer adverse tax consequences if the transfer is not carefully structured.⁷⁰ For example, an employer's contribution of property is a taxable event. Consequently, if a loss is realized as a result of a contribution to a trust, such loss would not be deductible because pursuant to IRC section 267⁷¹ the transaction would be considered an exchange between related taxpayers.

Section 404(a)(1) limits the yearly deduction for both normal costs and unfunded past service costs for both pension trusts and employee annuities. Normal costs are the current costs of funding the plan and is defined in the regulations as follows:⁷²

Normal costs for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled.

Unfunded past service costs are the portion of costs attributable to service before establishment of the plan which has not been funded. It is defined in the regulations as follows:⁷³

[The unfunded] [p]ast service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all future benefits provided under the plan which would not be met by future normal costs. . . .

Clause (A) of section 404(a)(1)⁷⁴ in general, limits the deduction for current costs to an employee annuity⁷⁵ or pension trust to an amount not in excess of 5 percent of the compensation paid or accrued to participating employees during the taxable year.⁷⁶

Clause (B) of section 404(a)(1) in general, provides that contributions in excess of 5 percent can be deducted if made to fund the unfunded portion of past or current service costs.⁷⁷

68. *Graybar Electric Co. v. Commissioner*, 267 F.2d 403 (2nd Cir. 1959).

69. *Wasatch Chemical Co. v. Commissioner*, 313 F.2d 843 (10th Cir. 1963) and *Steele Wholesale Builders Supply Co. v. United States*, 266 F. Supp. 82 (W.D. Tex. 1963) where the delivery of a promissory note was found to be payment. The Commissioner maintains that an unsecured note should be deductible only when paid. See Rev. Rul. 95, 1971-1 CUM. BULL. 130.

70. *Colorado National Bank of Denver*, 30 T.C. 933 (1958); *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960). *Tasty Baking Co. v. United States*, 393 F.2d 992 (Ct. Cl. 1968). *A.P. Smith Mfg. Co. v. United States*, 364 F.2d 831 (Ct. Cl. 1966).

71. CODE § 267 deals with "Losses, Expenses, and Interest with Respect to Transactions Between Related Taxpayers." See also *Dillard Paper Co. v. Commissioner*, 341 F.2d 897 (4th Cir. 1965) and Rev. Rul. 163, 1961-2 CUM. BULL. 58.

72. Treas. Reg. § 1.404(a)-6(a)(2) (1961).

73. *Id.*

74. CODE § 404(a)(1)(A).

75. CODE § 404(a)(2). Contributions for employee annuities subject to limitations imposed on pension trust.

76. Treas. Reg. § 1.404(a)-(4) (1961).

77. Treas. Reg. § 1.404(a)-5 (1961).

Clause (C) of section 404(a)(1) provides an alternative to the limitations of clauses (A) and (B). Under such clause a deduction, in general, is allowed for an amount equal to current costs plus 10 percent of past service costs or supplementary costs as determined in both cases under regulations prescribed by the Commissioner.⁷⁸

Where employer costs are not specifically designated, each contribution will be applied to current costs. If current costs are unfunded on the due date, costs may include interest on such unfunded costs. The costs are required to be reduced by any discount for portions funded before the due date.

Clause (D) of section 404(a)(1), in general, permits a carryover to future years of contributions in excess of amounts deductible under clauses (A), (B) or (C).⁷⁹

Under section 404(a)(3)(A) deductions for contributions to profit-sharing plans are limited to 15 percent of compensation otherwise paid or accrued subject to the reasonable compensation test under section 162.⁸⁰ Excessive contributions may be carried forward and deducted in future years subject to the 15 percent limitation.⁸¹

III. NEW LEGISLATION⁸²

If enacted, H.R.2,⁸³ The Employee Benefit Security Act of 1974, will bring several significant changes into the area of employee benefit plans. Its passage is expected in the current term. The bill has provoked much controversy. It has been called a feeble attempt to protect the interest of employees. Some specialists speculate that it may dampen the growth that has been experienced in recent years in the deferred compensation area. Its treatment here will be limited to a review of some of the more significant changes and a contrast with the present Code provisions.

The Senate version of H.R. 2 is H.R. 4200, Retirement Income Security for Employees Bill. Passed in September 1973, it is virtually identical to the House passed version, the major distinction being the absence of a "portability" requirement in H.R. 2.⁸⁴

*Retirement Savings (Bill Section 2002)*⁸⁵

The retirement savings provision is an entirely new concept in the area of employee benefit plans. It permits an employee who is not covered by

78. Treas. Reg. § 1.404(a)-6 (1961).

79. Treas. Reg. § 1.404(a)-7(1961).

80. Treas. Reg. § 1.404(a)-9(c)(1961). See also Rev. Rul. 366, 1956-2 CUM. BULL. 976, for requisites with regard to incurring liability.

81. Treas. Reg. § 1.404(a)-9(e)(1961), Treas. Reg. § 1.381(c)(11)-1(d)(3)(1972). See also Rev. Rule. 185, 1970-1 CUM. BULL. 109.

82. See, Goodman, *Legislative Development of the Federal Tax Treatment of Pension and Profit-Sharing Plans*, 49 TAXES 226, 229 (1971) for the history of the tax treatment of employee benefit plans.

83. H.R. 2, 93rd Cong., 1st Sess. (1974).

84. S. Res. 4200 92d Cong., 2d Sess. Title III (1973), would permit tax free transfer of vested benefits. The transfer would have to be the result of change of employment, and must be transferred to the new trust or annuity plan within 60 days of receipt.

85. Adding CODE § 219.

a qualified plan to contribute in his own behalf to a commercial retirement plan an amount equal to 20 per cent of his compensation includible in gross income, or \$1500, whichever is lesser. The great advantage here is that the taxpayer is permitted to exclude this sum from his gross income for any year in which he qualifies. A person would generally qualify if he did not participate in any qualified plan during the tax year in question.

*Lump Sum Distributions (Bill Section 2004)*⁸⁶

The 1969 Tax Reform Act eliminated capital gains treatment for lump sum distributions and substituted a seven year forward averaging method. Under the proposed legislation the forward averaging treatment is continued but the term is extended to 10 years.

*Participation (Bill Section 202 and 1011)*⁸⁷

Present Code section 401(a)(3)(A) prescribes that a plan will not qualify if it requires that employees have more than 5 years of service to participate. It does, however, permit exclusion based entirely upon age so long as the plan meets the percentage test and does not discriminate. The proposed amendments would prescribe maximum waiting periods before certain employees could participate in a plan.

*Vesting (Bill Section 203 and 1012)*⁸⁸

Current provisions under section 401(a) do not have any special rules regarding vesting of an employee's benefits under the plan. Nevertheless reliable sources in the industry indicate that a plan which does not provide for 100 per cent vesting within 10 years of service will not be given approval. It appears that the rationale behind this unwritten rule is that vesting requirements beyond a 10 year period will likely produce discrimination and not function for the exclusive benefit of employees.

The new legislation sets out detailed vesting schedules. Plans which are contributory must give 100 per cent vesting to accrued benefits derived from a participants own contributions. For plans created after January 1, 1974, three alternative vesting formulas would be available: (1) 100 per cent vesting after a specified period of service not to exceed 10 years; (2) 25 percent vesting after 5 years of service with an additional five percent vesting in each of the next five years (50% after 10 years); and a further 10 percent vesting in each of the succeeding five years (100% after 15 years); and (3) 50 percent vesting when the employee's age and years of service equal 45, provided that he has at least five years of service at the time with an additional 10 percent vesting in each of the succeeding five years.

Plans in existence on January 1, 1974 may use one of the alternatives above or a special transitional rule which would be available during the first five plan years to which the above vesting schedule applies. Scheduled vesting would have to be reached in the sixth year.

86. Amending CODE § 402(e).

87. Adding CODE § 410.

88. Adding CODE § 411.

*Minimum Funding Standards (Bill Section 302 and 1013)*⁸⁹

Present Code provisions do not contain minimum funding standards for qualified plans. The proposed bill contains provisions which require minimum funding for qualified plans. Normal costs would be funded currently, and plans in existence on January 1, 1974 would be required to amortize past service liabilities as of that date over 40 years or less. Past service liabilities arising in the future will be amortized over a period of 30 years or less. A 30 year requirement will also be made of plans with initial past service costs adopted after January 1, 1974.

The eye opening portion of this provision is that should an employer fail to meet the minimum funding requirements, a tax of 5 per cent of the accumulated deficiency would be imposed. If the deficiency remain uncorrected 90 days after notice of the deficiency, a tax equal to 100 percent of the uncorrected amount would be imposed. There is no deduction allowed for the amount of the tax imposed. The funding requirements provision applies to an employer who meets a "modified" interstate commerce test. Profit-sharing plans are exempted from this provision.

Plan Termination Insurance (Bill Section 409(a))

Those employee plans which are governed by the proposed funding requirements would also be required to purchase plan termination insurance. Part 4 of H.R.2 proposes to establish under the Department of Labor a non-profit corporation under the laws of the District of Columbia, to be known as the Pension Benefit Guaranty Corporation. It will be empowered to issue plan termination insurance to insure participants and beneficiaries of plans covered under the bill against loss of benefits arising from complete or partial termination of a plan.

Fiduciary Standards-Part 1 of H.R.2 (Bill Section 101-115)

Section 401(a) does not attempt to regulate the activity of the fiduciary under an employee plan, leaving the enforcement and regulation of the employee fund to state law. Part 1 of the proposed legislation will require disclosure on an annual basis and also create federal standards for the fiduciary relationship.

The disclosure provision requires publication of an annual financial statement to be filed with the Department of Labor, and to plan participants on a periodic basis. This disclosure must contain a description of the plan, along with a financial statement with respect to assets and liabilities received and distributed during the past year.

The second half of Part 1 sets out standards with respect to the conduct of a fiduciary under a plan. It generally requires that the fiduciary act in the interest of the plan participants and beneficiaries.

*Contributions and Benefits (Bill Section 2003)*⁹⁰

Both defined contribution plans and defined benefit plans are generally

89. Adding CODE § 412.

90. Adding CODE § 415.

subject to the limitations under section 404(a)(1) on deductible contributions with no limitations on benefits other than there be no discrimination. Under H.R. 2 contributions to a defined contribution plan would be restricted to the lesser of 25 percent of compensation or \$25,000. If a defined benefit plan is established, the amount of the annual benefit to an employee cannot exceed the lesser of \$75,000 or the employee's average compensation for his three highest years.