1964

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Recommended Citation
Sheldon M. Young, Miscellaneous Problems Involving Suspension and Termination of Pension Plans, 15 W. Rsrv. L. Rev. 667 (1964)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol15/iss4/6

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Miscellaneous Problems Involving Suspension and Termination of Pension Plans*

Sheldon M. Young

Revenue Ruling 55-186: A Brake Upon Intermittent Contributions To Profit-Sharing Plans

The Treasury Department, from the very inception of the enactment of section 165(a) of the Revenue Act of 1942, took the position that only a permanent program would qualify under that provision of law. Permanence implies among other things that recurrent contributions will be made to the plan. It is not surprising, therefore, to find the Commissioner stating in the regulations under the 1939 law that:

a profit-sharing plan ... is a plan established and maintained by an employer to provide for the participation in his profits, by his employees or their beneficiaries based on a definite predetermined formula for determining the profit to be shared and a definite predetermined formula for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death or severance of employment. A formula for determining the profit to be shared is definite for example if it provides for a contribution equal to (a) a specified percentage of the annual profits, (b) a specified percentage of the annual profits in excess of the sum of dividend commitments plus a fixed amount with an over-all limitation, or (c) a specified percentage of the annual profits not to exceed a specified per-

*This article is based on a Master's Thesis presented at Western Reserve University School of Law in 1962.

In the fall of 1962, the Internal Revenue Code was amended so as to include a new provision therein (§ 401(a)(7)). This article will not consider the impact of that statutory change on the subject matter discussed herein. It should be noted, however, that essentially, § 401(a)(7) provides that upon termination of a plan, all interests are non-forfeitable to the extent then funded. However, that statute goes on to state that the provision requiring non-forfeitalibability would not apply to benefits or contributions which, under Regulations adopted to preclude discrimination, may not be used for certain designated employees in the event of early termination of the plan. Subsequently, the Internal Revenue Service published Treasury Regulations 1.401-4(c)(2)-(5) inclusive. These substantially reiterate the rules originally promulgated in 1945 as Mimeograph 5717 restrictions.
centage of the salaries of the participants or their contributions if any to the fund.¹

The rule appeared to have a logical basis, and met with the approval of many pension planners who were otherwise critical of certain rules developed by the Treasury Department.² On the other hand, there were many critics of the rule who maintained that the Treasury was establishing a substantive rule of law not properly within the scope of the statute. Shortly after the enactment of section 165(a), several so-called “one shot” profit-sharing programs were adopted pursuant to which substantial portions of profit were contributed to a plan in one year. None of these programs stipulated a requirement of recurrent employer contributions. Since they were adopted during World War II when corporate tax rates were very high, the absence of a requirement for recurring contributions gave rise to the suspicion that they were devices to avoid tax rather than promote employer-employee relations. Nevertheless, deductions to a large number of these programs went unchallenged. In one case, however, the size of the single contribution, $1,000,000, was apparently large enough to invite a disallowance from the Treasury Department.

In Lincoln Elec. Co. Employees’ Profit-Sharing Trust,³ the court held that the Commissioner could not infer from the language in the regulation that the adjective “permanent” preceded the word “plan” so as to infuse the word “plan” with an interpretation that required recurring contributions. Turning to another part of the regulations (not quoted above), the court noted that the word “contributions,” a plural, when used in connection with the verbs “continue” and “discontinue” was too fortuitous to imply an intent on the part of the framers that recurrence thereof would be required. Moreover, the court stated that the trust itself should be examined to determine whether it furthered the statutory scheme, whether it was discriminatory and whether any funds could revert to the employer.

Was the court right? Certainly the use of the term “formula” in the 1939 Regulation implies that a mathematical method would be recurrently used to determine yearly contributions, for otherwise, the term

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² Clark, Profit Sharing and Pension Plans (Law and Taxes) 59 (1946).
³ Lincoln Elec. Co. Employees’ Profit-Sharing Trust, 14 T.C. 598 (1950), rev’d, 190 F.2d 326 (6th Cir. 1951). The writer has discussed this case with Mr. Leonard Williams, head of the Cleveland Office of the Pension Trust Section who originally ruled that the plan did not qualify, and with Mr. R.S. Jett, trustee involved in the litigation. Mr. Jett suggested that at least eight trusts similar to that involved in the Lincoln Electric case passed review without challenge. Mr. Williams advises that the challenge in Lincoln Electric was raised because of the large size of the deduction claimed.
"amount" would have sufficed, thus eliminating much of the text in that Regulation. If we examine the matter from the standpoint of furthering the "statutory scheme," it is to be noted that the Senate Committee\(^4\) took cognizance of the classical definition of a profit-sharing plan which was fixed by the International Cooperative Congress at its meeting in Paris in 1889. A profit-sharing plan was there defined as "an Agreement, freely entered into, by which employees receive a share, fixed in advance, of the profits." The Senate Committee stated, however, that it did not wish to be limited by this narrow term but rather by objectives which would (a) fortify our democratic form of government, (b) preserve our system of private capitalism, (c) ameliorate labor disputes, and (d) cement employer-employee relations. In the Lincoln Electric case, the court felt that a substantial endowment of $1,000,000 furthered these objectives. But, it remains to be seen whether, under conditions different from those in the Lincoln Electric case, such as a smaller contribution, slower vesting rate, and a high labor turnover, there is a furtherance of the "statutory scheme." If we examine the matter from the standpoint of discrimination, the Ryan School Retirement Trust\(^5\) case should be reviewed. It illustrates how a single contribution can search its way without intent into the accounts of those in whose favor discrimination may not exist in order to obtain tax qualification. The result is no different where there is a discriminatory motive in the timing of contributions. Certainly, the requirement of a recurring contribution by a healthy, profitable company considerably minimizes the hazards of manipulation which, because of the motive, produces results that fall within the purview of statutory discrimination. This is in contrast with the Ryan School case where discrimination was not present despite similar results.

**Predetermined Formula**

It was for these reasons that the Commissioner resisted the decision and unsuccessfully litigated the issue in the courts. Shortly before the enactment of the 1954 Internal Revenue Code, it had been decided that in the absence of a predetermined formula in a plan, the employer was free to contribute what he would to the program subject to his making proper accruals before the close of his tax year.\(^6\) However, where the employer's plan stipulated a definite predetermined formula, it had been held by the Tax Court that the taxpayer would be entitled to no greater

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A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or the 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 years, by 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. A formula for allocating the contribution among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant. A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under Section 401(a) if contributions for the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.

About the time that the Service was preparing this regulation repealing its prior requirement of a predetermined formula, and shortly before the Tax Court published its decision in the Ryan School case, Revenue Ruling 55-186 was published. In Revenue Ruling 55-186, the Service held that in order for a plan to qualify, it must contain a pro-

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10. Treas. Reg. § 1.401-1 (b) (1) (ii) (1956) [hereinafter cited as Reg. §1], as amended, T.D. 6675, 1965 INT. REV. BULL. NO. 41, at 37. Later, the service issued rulings which completely acquiesced in the position taken by the courts. In Rev. Proc. 56-22, 1956-2 CUM. BULL. 1380, the Service ruled that a previously issued favorable determination letter would apply to a plan as amended if the sole purpose of an amendment would be to remove a stipulation for a predetermined formula.
vision that in the event of discontinuance of contributions, the rights of participants would be fully vested therein as upon termination of the program. It will be recalled from the *Ryan School* case that, where contributions had been discontinued and several participants had terminated employment following the termination, the forfeitures had searched their way into the accounts of the remaining participants and had thereby created a large increment in the accounts of the highest paid participants. One can only suspect that the Service published Revenue Ruling 55-186 in anticipation of the adverse decision later rendered in the *Ryan School* case. The effect of the rule is to prevent forfeitures upon discontinuance of contributions, for with full vesting on discontinuance of contribution, such as on termination of a plan, forfeiture will not occur and a situation such as *Ryan School* could not occur.

Coming at the time when the Service was abandoning its requirement for a definite predetermined formula in a profit-sharing plan, the ruling was as a cloud obscuring the clarity of the rule. Did the Service really mean that one need not have a predetermined formula? If so, what good was it not to have a definite predetermined formula with the right to suspend contributions for a few years if the result of such suspension would be to fully vest the employees in order to obtain qualification of the plan, for the agents in the Service interpreted the word suspension as being synonymous with discontinuance.

To further confuse the issue, Treasury PS 57 must also be considered. Treasury PS 57 concerns not a profit-sharing plan but a pension plan, and in answer to the question as to when contributions to a pension plan could be suspended without impairing qualification, the Service held that this could be done so long as: (a) benefits were not affected, and (b) the contributions to the plan were sufficient to cover the normal cost plus the interest on the unfunded past service liability. Since a deduction taken on the basis of a normal cost plus one-tenth of the past service liability will build up a cushion in current years against future contributions under this provision, it is possible to have suspensions of contributions to a program without in fact impairing the qualified status. Since Revenue Ruling 55-186 did not distinguish between pension and profit-sharing plans, the issue arose, following the publication of Revenue Ruling 55-186, as to the applicability of Treasury PS 57.

A year after the issuance of Revenue Ruling 55-186, the Service published Revenue Ruling 56-596. In essence, the Service held that so long as the requirements of Treasury PS 57 were met, it would not be necessary in pension plan cases to invoke the full vesting of equities re-

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12. P.S. Rulings are Pension Trust Division Information Releases. [P.S. Rulings may be found in 2 P-H Pension & Profit Sharing Serv. § 12,502 and are hereinafter cited as P.S. No.].
quired by Revenue Ruling 55-186 merely because a contribution was skipped in one year.

Predetermination of Qualification

In Revenue Ruling 56-596, the Service also stated that the facts would be examined to determine whether a suspension of contributions in the case of a profit-sharing plan would be a discontinuance of contributions in a particular case. The ruling stated that the employer and the trustee were to notify the Commissioner at any time that there would be a suspension or discontinuance in order that a redetermination regarding qualification could be made. On occasion, the Service has gone further. The various pension trust sections in the various offices of the Director of Internal Revenue exercise a degree of latitude in applying the rules which they may impose prior to issuing a determination letter ruling favorably upon the qualification of a plan. In certain districts there has been a refusal to approve a plan in advance, unless it contains a clause to the effect that a certain minimum contribution to the plan be made each year. This seems to be in conflict with the rule developed by the Treasury Department that inclusion in advance of such provisions will not eliminate the necessity of including provisions in a plan to fulfill compliance with Revenue Ruling 55-186.

The effect of Revenue Ruling 55-186, as modified by Revenue Ruling 56-596, is, therefore, to neutralize the decision of the court in the Ryan School case. While a formal requirement for recurring contributions is not a prerequisite for qualification, a stipulation in the plan that discontinuance will be treated as a termination would prevent a result similar to that in Ryan School even though the absence of a bad motive would cause a court to refuse to construe such a result as discrimination within the scope of the statute. Securing a favorable determination letter assures the employer of his deduction, allows him to invest in "pooled-funds" for qualified trusts, and has certain other practical advantages. Hence, it is not likely that the results in the Ryan School case will arise again, for the Service will apparently refuse to issue a favorable determination letter unless the profit-sharing plan contains a clause complying with Revenue Ruling 55-186. This ruling seems to support the statutory scheme, for however proper the motive of the principals in the Ryan School case, the results must be admitted to be bad. The ruling states in effect that while the holding in the Lincoln Electric case must be conceded, evils can arise because of the irregular timing of contributions.

16. Is it possible that the Service was not so much concerned with the "evils" as with a desire to enrich the tax coffers during a period of high taxation by blocking plans with no
The incidence of these evils will be minimized by having full vesting take place if contributions are discontinued. Moreover, should contributions be suspended, the Service must be advised in order that it may determine whether the motive in timing contributions was to favor the "prohibited group."

TREASURY PS 57: A BRAKE UPON INTERMITTENT CONTRIBUTIONS

In part 2(h) of Revenue Ruling 57-163,17 the Service restated a position which it has taken from the publication of the earliest regulations established in connection with plans designed to qualify for tax privileges. A "plan," says the Service, is a permanent and continuing program. Yet as was seen in the Lincoln Electric18 case, the Sixth Circuit Court of Appeals and the dissenting judges in the Tax Court did not agree with the Commissioner that a program must be permanent for purposes of the statute. As noted previously in this article,19 PS 57 holds that contributions to a plan may be suspended without affecting prior rulings respecting qualification, provided however that payment of benefits is not affected thereby, and that the unfunded past service cost at any time, including any unfunded prior normal cost and unfunded interest on any unfunded cost, does not exceed the past service cost as of the date of establishment of the plan. Revenue Ruling 56-596 has extended this requirement by holding that the unfunded cost for purposes of the rule includes unfunded costs added by the amendment. Presumably, the right to make such rulings is grounded on the thesis that the "statutory word 'plan' implies 'permanent plan,' and 'permanent plan,' as to funded pension benefits, implies a minimum standard of actuarial adequacy or soundness."20 Although a profit-sharing plan was the topic of consideration in the Lincoln Electric case, the reasoning of the court may cast some doubt upon this thesis.21

It is a basic principle of law that income tax statutes will be strictly construed whereas social legislation will be liberally construed. In section 401(a) of the 1954 Internal Revenue Code and its predecessor, section 165(a) of the 1939 Internal Revenue Code, as amended, there can be found a socially inspired tax statute; hence, a miscegenous marriage requirements for recurring contributions? In the Lincoln Electric case, the government lost $850,000 from what it claimed in taxes. How much it garnered by a rule which discouraged similar plans cannot be estimated.

19. See note 12 supra and accompanying text.
20. PATTERSON, LEGAL PROTECTION OF PRIVATE PENSION EXPECTATIONS 92 (1960).
21. Ibid.
of principles of construction results. However, the position taken thus far by the Tax Court and by the courts of appeal indicates that these statutes are to be treated in their social context rather than in their tax context. In other words, they are to be construed liberally rather than strictly. That being the case, the question arises as to whether Treasury PS 57 promotes the purpose of Congress when it requires that contributions to a pension plan be made so as to prevent its original unfunded liabilities from increasing.

In this context, the Lincoln Electric case is of doubtful assistance, for it dealt with a profit-sharing plan. The contribution of $1,000,000 in that case was cited by the court as possibly promoting the statutory scheme in view of the fact that a one sum payment of that amount could, through capital increases and interest income over the future years of the trust, produce a greater effect for the benefit of the individuals involved than the mere contribution of several sums over a period of years, such as $100,000 a year for 10 years. Dealing with a pension plan, however, is an entirely different matter; from its very nature it demands continuation for years and even into perpetuity. In order to meet the requirement of payment of benefits from such a plan, repeated actuarial valuations are required, at least in self-insured plans, in order to determine what sums of money must be contributed in order to maintain actuarial solvency. A ruling which requires that an employer evaluate liabilities regularly and contribute systematically in order to maintain a pension program on an even keel should be treated differently than a comparable ruling which has been judicially struck down where the comparable ruling applies to a profit-sharing plan. The latter is a different type of program, albeit authorized by conjunctive text in the statute authorizing the deduction to the pension plan.

One might suspect however, that such a requirement could have a discouraging effect on the adoption of such programs. While nothing in the qualification provisions of the statute requires that an employer retain an actuary, the deduction provisions of section 404 of the Internal Revenue Code make it clear that retaining an actuary is necessary in order to determine the maximum deductions. For example, if an employer claims his deduction under section 404(a)(1)(A) of the Code, section 1.404(a)-4 of the Regulations requires the filing of an actuarial certificate of the amount reasonably necessary to pay the unfunded past service liability and current service credits. The statute provides that the Commissioner may reduce the five per cent of payroll deduction upon periodical examination at not less than five year intervals, and the Regulations indicate that actuarial certificates shall be filed upon request. Further, if the employer takes a deduction under section 404(a)(1)(C), it becomes necessary for the employer to determine the amount of the
past service liability in order that a deduction equal to no more than ten per cent of the unfunded initial past service liability be taken in any year. Sections 1.404(a)-4 and 1.404(a)-6 of the Regulations, which were issued in connection with these provisions, adequately indicate that a statement of the methods, factors, and assumptions employed by the actuary in determining the contributions to the plan must be filed.

This vocabulary is probably confusing to the uninitiated who may rightly ask, "What is unfunded cost?" It is defined in section 1.404-4(b) of the Regulations as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for that year. Normal cost is defined in a later part of section 1.404-6(a) of the Regulations as follows:

[Normal cost 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. Past service or supplementary cost at any time is the amount actuarially determined which would be required to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.22

**Accrued Liability Defined**

In other publications (notably the Bureau Bulletin on 23(p)(1)(A) and (B)) the Service has considered various actuarial techniques for computing pension costs. These rulings are quite intricate, and because of their technicality they do not lend themselves to easy understanding. Therefore, it is better to turn to other sources for more easily understood definitions. A more meaningful definition of "accrued liability" is as follows:

Accrued liability for past service is the actuarially calculated lump sum payment that would have to be made by companies at the date of origin of the plan in order to discharge fully the assumed obligation for service already completed by employees who may be expected to remain with the company until retirement age. In effect it is the amount required to compensate for the fact that companies did not install a pension system at an earlier date and make current provisions for accumulating pension credits of their work force.

Accrued liability may also be defined as "the single-sum, total cost of a pension plan that would pay benefits based only on service up to the present time." (Technically, the aggregate past service cost at any time represents the value at that time of that portion of the total estimated cost of the plan which is attributable to prior years)...23

23. DEARING, INDUSTRIAL PENSIONS 137 n.9 (1954).
Good descriptions of how accrued liability is calculated are equally hard to find. The following is perhaps as good as any.

First . . . [actuaries] compute, for the pension group, how much the eventual pensions will probably come to — taking into account such factors as labor turnover, mortality rate, and interest on pension monies. Then they figure "current service cost" [normal cost]. That's the amount of payment required annually — plus earned interest — to pay pensions to survivors based on their service from the time the funding starts.

Burden of Past — But at that point the actuaries are just beginning to sharpen their pencils. (For the worker's pension has to include his service before the pension plan started.) So the actuaries figure "past service cost" — the amount that would have accumulated up to that time if the plan had been operating. And in figuring this, the actuaries don't stop at the annual sums that would have been paid in; they add in the interest that would have been piling up year by year.24

It is well to note at this point that neither the Internal Revenue Code nor the Regulations require an employer to pay off the past service liability. If there were such a requirement, the effect would be to impose upon the taxpayer a more stringent set of requirements than those imposed by Treasury PS 57. To illustrate this point it is helpful to examine the comparative pension law and procedures in vogue at one time in Canada. Under section 76(1) of the Canadian Income Tax Act,25 if contributions are made to a registered superannuation fund

in respect of past services pursuant to a recommendation by a qualified actuary in whose opinion the resources of the fund or plan required to be augmented by the amount of one or more special payments to ensure that all obligations of the fund or plan to employees may be discharged in full — and the payment has been approved by the Minister on the advice of the Superintendent of Insurance there may be deducted in computing the income for the taxation year the lesser of (a) 1/10 of the whole amount so recommended to be paid . . . 26

With these statutory guideposts, probably inserted in order to charge the agency best equipped to determine the correctness of the size of a deduction claimed rather than the propriety of claiming it, the Superintendent of Insurance took the position that deductions should not be granted to actuarially unsound plans. Furthermore, he consistently refused to grant advice that a payment for past services was deductible unless the Ministry of Insurance was satisfied that there was a final date27 for fully

26. Ibid.
27. Cf. DEPARTMENT OF NATIONAL REVENUE, INFORMATION BULL. NO. 14, pts. 9(e)(1) (b), (2) where the text of certificates required of an actuary with respect to past service contributions under both an insured and trusted pension plan is stipulated. That of a funded pension trust reads as follows:

I hereby certify that in my opinion the assets of the pension fund of (name of em-
paying off the past service obligation. Also, in cases involving only a few lives, the Ministry of Insurance had to be satisfied that there was an express provision in the program that on retirement the full reserve would be in the fund for payment of the annuity to a pensioner. This position is far less flexible than that taken by actuaries in the Bureau of Internal Revenue who first drew the text of Treasury PS 57. However, it must be noted that our statute did not give them the breadth of control contained in the Canadian statute. In our country, the tax authorities have had to breathe actuarial soundness into the meaning of the word "plan" in order to require valuations, whereas in Canada the express provisions of law clearly empowered actuaries to pass upon and make rules for plans before deductions would be allowed.

In either nation, the economic problems faced by an employer require that he have some flexibility in meeting his pension funding commitment. With the maximum deductible contribution fixed by statute, and the minimum fixed by ruling, a tax deductible range of contribution has developed, all based upon computations involving the past service liability. Commenting on this range, one writer made the following summary of its practical effect in the United States.

When a company makes a decision to go into the process of full funding, it sets up something in the nature of a mortgage — and a sizable one — on its future operations. It's a type of financial operation that can add little or nothing to productivity, and the obligation can be liquidated only out of accumulated reserves or future profits.

Yet this new type of mortgage gives management a spanking new financial tool, one it's just learning how to handle. For the lack of any IRS time limit gives management some leeway. In effect, past service liability can work like a giant open-end mortgage which can be paid off during the good years and even provide a nest egg for the lean ones.

Suppose a company had a $500 million past service obligation which it was funding on a 10-year basis. That would mean setting aside $50 million a year (leaving interest out of the calculation). In high-profit years, this makes good sense; after tax profits would be down $25 million, but the tax collector would get $25 million less.

Then after five years, suppose the company hits rough financial weather. It could shift to a 30 year funding basis for past service, while maintaining present service payments. That preserves the financial integrity of the pension plan, yet slices the annual contribution in half. Earnings look better, and the company conserves cash.

Or it could go further, as U.S. Steel did. Funding on a 10% basis, (which actually boils down to an 11 1/2 year period) the corporation
reduced its past service liability by $297 million from 1950 through 1957. This past year, with earnings down, it decided to forego past service funding, used the money instead for new plant and equipment.

Of course, a company can never withdraw past contribution, already made to the pension fund. But in a dire cash pinch, it can make a bookkeeping shift — transferring, say $25 million from the accumulated past service fund to the present service account as the current year's present service contribution.

This could permit a company to skip its present service payment and might help put black ink on its income statement in a bad year.  

Labor Negotiated Plans

Treasury PS 57 has, therefore, bred into the environment of pension planning the concept that there is a safe area of maximum and minimum financing. It should be strongly emphasized that this is a "tax-safe" area, and that funding at the minimum required by PS 57 does not guarantee solvency or a continuation of pension payments should a plan terminate. This was vividly pointed out in the course of a debate between representatives of the steel industry and Mr. Murray Latimer, actuary for the United Steelworkers of America, during the inception of labor negotiated pension plans. In 1949, negotiations between the parties reached a stalemate on the question of whether the pension plan to be adopted should be contributory, as demanded by the industry, or non-contributory, as demanded by the union. This introduced the question of cost with United States Steel maintaining that on the basis of its statistics, the plan demanded by the union would initially impose upon it a debt of one billion dollars due to past service liability. Mr. Latimer, on the other hand, contended that this liability need only be "frozen," i.e., it would create a frozen initial past service liability. If it were placed in a fund, said Mr. Latimer, it would have an economic function, namely the earning of interest. Therefore, the union proposed that interest alone on the debt plus the normal cost be paid — essentially that Treasury PS 57 be met. Mr. Latimer stated that this would cover all payments due pensioners. The presumption in the union's agreement was that the plan

28. *The Startling Impact of Private Pension Plans*, Business Week, Jan. 31, 1959, p. 95. In Canada, a measure of this flexibility has been obtained by having the actuary's certificate stipulate, *inter alia*: "I recommend that this amount be paid into the fund over a period of not less than twenty (20) years." See note 27 supra. This has been found acceptable.  
29. See *Davenport, Pensions, Not If but How*, Fortune Magazine, Nov. 1949, p. 82.  
30. Id. at 218. Were the actuaries correct? Note the figure of the reduced past service liabilities in *The Startling Impact of Private Pension Plans*, Business Week, Jan. 31, 1959, p. 97.  
32. Mr. Latimer made a similar statement which is reported in Weiss, *Funding Practices Under Labor Negotiated Pension Plans*, in 2 PROCEEDINGS OF THE CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 71 (1952).
would be a continuing affair running into perpetuity. But, the weakness in this position as it applies to smaller companies was aptly summarized by one writer as follows:

The Latimer Plan for freezing past service liability introduces obvious risks, especially for smaller companies. For if a company goes bankrupt, or the plan is simply terminated there will be no funds accumulated to continue the pension benefits of those already retired, let alone those hoping to retire. Mr. Latimer's argument for freezing instead of amortizing appeared to be opportunistic — an effort to show how low pension costs could be without citing the risks. Conservative actuaries insist that a plan should be fully funded within twenty-five or thirty years or sooner. Since the government will allow tax exemption on only 10 per cent of the past-service liability each year, most companies amortize over a period of eleven or more years.38

The importance of this point cannot be minimized in this article for company after company has bargained to install the "steel plan." Such plans are usually patterned after the one negotiated by United States Steel or Bethlehem Steel, and the text often prepared in Pittsburgh by the union's attorneys follows the text of one of those two plans. However, it must not be thought that so fine an actuary as Mr. Latimer was ignorant of the weaknesses in "interest only" payments. While the plans negotiated with United States Steel and some others have stipulated that the company is free to determine the amount of contributions to be made, contracts presented by the United Steelworkers Union to smaller companies have contained clauses demanding that the plans be financed on a basis known as "terminal funding." One authority has described the method of computation under such a "terminal funding" basis as follows:

Under terminal funding the lump sum value of the pension is paid into the plan upon each member's retirement. In some instances an attempt at leveling such payments is made by projecting the amount required under this method over some fixed future period, such as five years, and then computing the level payment which if paid over the five years will equal the total required. Under either straight terminal funding or the modification described, full reserves required to meet benefits of the members retiring are paid over to the plan as and when they retire, but nothing is accumulated as respects benefits accruing to members presently on the active payroll.34

It is clear that this method, if employed, can result in staccato payments, with a regularity dictated only by the regularity of retirements and payments to retirants. Unlike the Canadian Income Tax Act35 which spe-

33. Davenport, op. cit. supra note 29, at 218. See also BRONSON, CONCEPTS OF ACTUARIAL SOUNDNESS IN PENSION PLANS 98-99 (1957).
35. See note 25 supra and accompanying text.
specifically allows a deduction for a contribution made to a plan that requires terminal funding, our Internal Revenue Code says nothing about deductions to plans handled on a terminal funding basis. In response to questions concerning terminal funding, the Service issued Treasury PS 67 which sets forth certain criteria under which contributions made to plans requiring this type of financing will be construed as contributions made to a deductible program:

(1) Nothing in any document indicates an intent to discontinue the program.

(2) There is in some publication made known to the employees generally the intention of the employer to establish and continue the program.

(3) There is an explicit provision for liquidating the plan.

In various cases discussed in the course of the ruling, the Service makes it clear that if the plan is designed to cover only those who are to retire, deductions will not be allowed except to the extent that they are applied for the benefit of those who in fact do retire during the period fixed for the duration of the contract for the plan, and then only to the extent permitted by the applicable provisions of the statute.

If the employer is required by his union contract to contribute to a plan, there is no question about the existence of a fixed liability under the law. Hence, there is a satisfaction of the general requirements of the tax statutes. Treasury PS 67 is probably right in gauging the deductions taken according to those who in fact can retire during the term of the contract. But if Treasury PS 67 and Treasury PS 57 are read together, one may note the possibility of a peculiar situation. By the terms of the union contract, an employer may be required to establish a plan which meets Treasury Department "approval," an "approval" which he cannot retain unless he contributes regularly and systematically to meet the requirements of PS 57. At the same time, however, the requirements of the union contract may be such that there is no need for him to contribute since no one, in fact, retires. If he does not contribute, it would appear that he cannot satisfy Treasury PS 57, and if he does contribute, he may receive no deduction. The answer to this seemingly irreconcilable situation will not be found in rulings. However, in an article by Mr. Isidore Goodman, Technical Advisor in Charge, Pension Trust Branch, Internal Revenue Service, the position of the Service with respect to union negotiated plans providing for terminal funding is summarized as follows: Since such plans cover the rank-and-file, there is no problem of discrimination. While failure to make contributions to such plans will be looked upon with

suspicion, there is a "valid business reason" therefor. As will be discussed more thoroughly later in this article, a "valid business reason" is required to be presented upon termination or curtailment of a program in order to procure from the Service a ruling to the effect that prior rulings on qualification of a program have not or will not be impaired. Here, however, a determination as to the consequences of the suspension are not required for, as Mr. Goodman stated, the "valid business reason" was originally established by a contract which envisioned contributions only when and if there are retirements.

**Terminal Funding**

It should be made clear that employment of "terminal funding" by a taxpayer has certain disadvantages. From the business point of view, "the danger is that of setting the plan forth to provide benefits the cost of which will emerge as an intolerable burden upon the finances of the employer within twenty or thirty years from the inception of the plan." In other words, it is current joy and delayed agony for a going enterprise. From a tax point of view, "terminal funding" eliminates the advantage of taking deductions during the current era of prosperity at what many consider to be abnormally high tax rates, and postponing payments to a time when both rates and profits may be low. Moreover, the size of the contribution at the later time may be actually so large as not to fall within the maximum permitted by law. While the article by Mr. Goodman is entitled to great respect, it is fairly obscure, and many agents in the Service, unaware of it, have in certain cases threatened to disqualify terminally funded plans because of failure to meet PS 57. Because of such inherent defects, many an employer has sought to solve his problem by having a "double document" arrangement.

A pension plan for purposes of the Internal Revenue Code is a program established by the employer. If the employer chooses to establish a plan to implement a union contract, that is his privilege. Therefore, an employer with a "steel plan" frequently establishes a plan whose provisions virtually repeat, with some major exceptions, item by item the provisions of the union contract. Among these are the provisions in the contract relating to funding. Often the employer will insert a provision in his tax qualifying plan that the company is free to contribute to the plan from time to time in such amounts as its board of directors shall determine, but no less than it is required to contribute by its collective bargaining

38. BUCK, op. cit. supra note 34, at 130.
39. Its advantage, business-wise, lies in the fact that it enables an employer about to close down an enterprise to contribute less than he otherwise would.
agreement. The net effect of such a provision is to establish a minimum contribution to the plan while at the same time leaving the employer free to contribute additional sums. In this way, both Treasury PS 57 and the minimum requirements of the union contract are satisfied. However, if reference to a minimum contribution in a tax qualifying plan is absent, the question arises as to whether an employer who fails to meet PS 57 should be exposed to disqualification. The answer to this question is that it is not the employer who suffers disqualification, but rather his plan and trust. If the plan is disqualified, the beneficiaries of the trust as well as the employer suffer, for lack of qualification means tax to the beneficiary to the extent of his vested interest and tax upon the income of the fund which can minimize the benefits. Therefore, the presence or absence in the text of the tax qualifying plan of the minimum contribution required by union contract should not result in disqualification, for permanence may be proved and sanctions imposed which do not further the social purposes of the law.

Auto Workers Plan

Treasury PS 67 is not, however, the only ruling published by the Service in connection with funding practices under union negotiated plans. A second ruling that is frequently applied is Treasury PS 64 which was designed to meet the requirements of plans negotiated by auto workers and their employers. These plans frequently negotiated by the UAW have stipulated that the employer would contribute to the plan at the rate of so many "cents-per-hour" for each hour actually worked by the employees in the bargaining unit, or every hour for which employees in the bargaining unit were compensated. It became obvious, however, that contributions at such a stipulated rate might fail to meet the requirements of PS 57. In essence, PS 64 stipulates that the deduction under such circumstances will be allowed provided the employer certifies that he accepts as reasonable the methods and assumptions employed in computations made by an actuary to the effect that the expected contributions during the term of the union contract will not be less than the full current cost of the prospective benefits, nor less than the normal cost plus interest accruing on the unfunded past service cost. In essence, the document required in order to secure a grant of qualification must include the actuary's certification that the rate of contributions will be more than sufficient to meet at least the requirements of Treasury PS 57.40

40. The author has been advised by persons formerly with the Pension Trust Branch, Internal Revenue Service, that PS 64 was adopted to avoid a "hot potato." Loosely, the phrase "approved by the Internal Revenue Service" has been thought to indicate that the Service, despite its disclaimer in determination letters, passes upon and approves the actuarial soundness of pension plans. Actually, the Service does no more than rule that plans do not discriminate. To avoid unfavorable publicity, however, the Service sought to force negotiating parties to secure valuations under the guise of "proof of permanence."
It must be emphasized again that a certification made pursuant to Treasury PS 64 will not guarantee actuarial solvency. Generally, the actuary renders his certificate on the basis of an assumption that so many employees work so many hours and that so many will retire during the term of the union contract. Suppose, however, that the number of hours worked and the consequent number of hours with respect to which contributions are made, drops substantially. This can happen in the case of a substantial lay-off or curtailment in work force. Also, the number of employees who retire may be greater than expected, as can happen if the plant closes down and the plan terminates simultaneously with all eligible to retire then entering upon the pension rolls. In the latter instance, the "depth of the funding" will not have been sufficient to carry the benefits on the occurrence of the contingency stated. As a counterbalance, the market value of a trust portfolio at the time of termination may have so increased as to outweigh the factors, leaving the benefits for provisions unfunded. Although the expectations of the actuary may have been reasonable, he still does not have a crystal ball to forecast the economic success or failure of a marginal producer. Hence, it may be concluded as noted previously that PS 64, like PS 57, does no more than encourage actuarial consultation. It places a sensible brake upon exuberant expenditure for unrealistic pensions. It does not, and is not intended to guarantee the payment of benefits where the vicissitudes of a free economy produce consequences which no one should expect the actuary to anticipate.

Mine Workers Plan

At this point, it might be helpful to examine whether Congress has ever expressed approval of these rules which place a brake upon the making of intermittent contributions to a pension plan. The "cents-per-hour" type of plan was preceded by the "cents-per-ton" type of plan, negotiated during the time following government seizure of the coal industry. In 1946, an agreement for such a plan had been reached between Julius King, Secretary of the Interior, and John L. Lewis, President of the United Mine Workers.41 Doubt existed, however, as to whether that plan ever qualified under amended section 165(a) of the Internal Revenue Code of 1939.42 Therefore, when Congress amended the Code in 1954, a specific provision was included in the statute to permit deductions to be taken for contributions in order to establish that payments to the Mine Workers Funds were deductible. The provisions of section 404(c) of the 1954 Internal Revenue Code specifically provide that if contributions are paid by an employer to a pension plan as a result of an agreement

41. For a general discussion of the UAW type plan see Weiss, op. cit. supra note 32, at 73-75.
42. Id. at 98.
reached between the employee representatives and the government of the United States, under certain conditions the amounts thereof will not be deductible under section 404, but will be deductible under section 162. Hence, it might be suggested that since the plan probably did not meet the tests of Treasury PS 64, Congress tacitly acquiesced to PS 64 by passing special legislation to avoid the application of the rule to cases where it would be unfair to do so. However, reference to that part of the Senate Committee report on the subject suggests that such was not the case.\textsuperscript{43} The Committee made the following statement as to the reason for inclusion.

Under present law, certain plans established as a result of negotiation with unions do not constitute qualified plans because they do not segregate pension funds from funds used for other purposes and do not satisfy other rules required for qualification. This may have the result of denying employers deductions for contributions to such plans because present law, which is retained by your Committee, does not allow deductions for contributions for non-qualified plans where employee rights are forfeitable.

Your Committee feels that this denial of deductions for employer contributions is inequitable where a negotiated plan was established during a period of Government Operation. Your Committee's bill therefore provides that employers shall be entitled to deduct as business expenses contributions made to plans established before January 1, 1954, which are the result of an agreement between employee representatives and the United States Government during a period of government seizure and operation of most of the productive facilities of the industry. This provision does not appear in the House Bill.\textsuperscript{44}

This report does not indicate confirmation or approbation of the rules which deny deduction; rather, it indicates that the denial of the deduction under the circumstances is inequitable. Also, the Senate Technical Report indicates that the primary reason for the adoption of section 404(c) was to assure employers of a deduction for a contribution made where the adoption of a pension program had been compelled as a result of governmental action during a period of seizure.\textsuperscript{45} No reference is made to the other rules. The Senate Technical Report indicates that the Senate was concerned with the fact that certain welfare benefits such as medical and hospital care as well as pensions were paid from a trust similar to the type used by the United Mine Workers, a fact which, even had it met PS 64, would not have permitted qualification under section 401.

Summarizing this point, it can be concluded that so long as the test of PS 57 is met, the government permits great latitude in the procedure which a taxpayer may adopt in paying pension plan liabilities. However, PS 57 does not require and is not intended to require that pension plans

\textsuperscript{43} CCH Pension Plan Guide \textsuperscript{\textcopyright} 11629.
\textsuperscript{44} Ibid.
\textsuperscript{45} Ibid.
be funded on a basis such that the reserves thereof will support the pensions granted during the lifetime of the plan. If a plan is funded at the minimum rate required by PS 57, i.e., if contributions are made so as to meet normal cost plus interest on the past service liability, it does not follow that the fund resulting will contain such reserves. If the purpose of our law were to effect such security, a minimum would be required akin to that once demanded by the Canadian Superintendent of Insurance for registration of a superannuation plan under the Canadian Income Tax Act. The effect of a violation of PS 57 is to run the risks, among others, of loss of qualification, right to deduction, resultant taxation of fund income, and taxation of employees to the extent of their vested right in company contributions. As modified by Revenue Ruling 56-596, it is also possible to find that benefits may have become fully vested, which may be regarded as a sanction.46 In short, it does not assure “complete depth of funding”; rather, it does, by requiring a minimum, encourage a sound actuarial approach to the financing of a pension plan going beyond the Treasury Department Regulations which require proof of intermittent valuations solely to determine if contributions fall below a statutory maximum.

Statutory Scheme Test

The validity of Treasury PS 57 in subsequent litigation should be determined not by reference to those words in the Lincoln Electric case wherein the court alluded to the fact that permanence is not a requirement of a plan, but rather to the reason that it was held that permanence is not such a requirement. In this respect, the court stated that the statutory objectives could be fulfilled by a single payment to a profit-sharing plan. Obviously, it may be better to qualify by intermittent contributions, or still better by regular and systematic contributions to a profit-sharing plan. A profit-sharing plan does not, by its nature, presume repeated contributions; rather, by its very nature it contemplates contribution from profit only as the business demands. On the other hand, a pension plan, by its nature, holds forth the expectation that at a future time benefits of a fixed number of dollars will be paid. A ruling which promotes the fulfillment of this expectation meets the “statutory scheme,” for that scheme must be presumed to contemplate payment of the benefits. Further, because of the text of the deduction provisions, the "statutory scheme" can be presumed to expect that funding will be determined on an actuarial basis.

Even if PS 57 should prove to be valid in a court case, it does not follow that PS 64 would also be held valid, or that PS 57 is to be invoked whenever a union negotiated plan fails to meet its tests. In the case of

46. Patterson, op. cit. supra note 20, at 93.
such a negotiated plan, it must be recognized that the employees have elected, in lieu of a wage increase, a deferred payment. If they want to waive actuarial solvency, or approach it from a position different from the one employed as a standard, that is the concern of the employees and their representatives. Perhaps now that the Welfare and Pension Plans Disclosure Act of 1958 is in force, with the avowed purpose of encouraging self-help, there will be reason for the Treasury Department to retreat from its paternalistic role and allow the unions to employ the information required to be filed under the law to promote sound funding. That, it is submitted, is the function of collective bargaining where a plan is the subject of contract and not of a tax agency. This reasoning does not, of course, apply to non-contractual programs where Congress has charged the tax agency with specific social enforcement powers.

A FURTHER BRAKE ON SUSPENDING CONTRIBUTION TO A PENSION PLAN — MIMEOGRAPH 5717

In a previous article, the provisions of Mimeograph 5717 were considered in connection with termination of a plan. Paragraph five of Mimeograph 5717 provides that payment of retirement benefits to employees may be continued under certain conditions, one of which is that “the full current costs of the plan have been met” even though the effect of such payments is to exceed the limits set forth in paragraph three of Mimeograph 5717. In this respect the definition of the term “full current costs” in paragraph 9(d) of Mimeograph 5717 provides that the term means the normal cost of a plan plus interest for such period on the unfunded past service liability. The Mimeograph continues parenthetically, as follows:

The full current costs will always be met in the case of an individual level premium insurance or annuity contract if the annual premiums are always paid; in the case of group annuity contracts if the current service costs are paid and payments for past service costs are sufficient to keep the unfunded past service cost from increasing; and in the case of self-insured plans if payments are made to the funds so that the initial unfunded liability does not increase.

It is thus established that there is an interrelationship between the definitions of “full current costs” for purposes of Mimeograph 5717 and Treasury PS 57. At the time Mimeograph 5717 was published, the employment of plans which used ordinary life insurance contracts coupled with side investment funds, from which money was taken at retirement age to

49. Paragraph 3 of Mimeograph 5717 [hereinafter cited as Mim.] sets forth the formula of the unrestricted maximum.
50. Mim. 5717, para. 9(d), 1944 CUM. BULL. 323.
be combined with the cash values at retirement age of the insurance contract to purchase a contract, were not much in vogue. At the present time, however, such plans are by far the most common being initiated in connection with the use of life insurance. In Revenue Ruling 55-480, the Service responded to the question as to when contributions to such a plan could be suspended by citing PS 57. It may be presumed, therefore, that the tests established by Mimeograph 5717 in connection with PS 57 will be used to determine the applicability of Mimeograph 5717 to such plans.

Suppose that a pension plan fails to meet the requirements of Treasury PS 57 because an employer fails to meet the full current cost of his pension plan. If the plan is a self-funded program, i.e., none of the monies have been remitted to an insurer, it is fairly simple to reduce the payments being made to a retired employee to an amount which is in accord with the amount of his pension multiplied by the ratio of the then unrestricted maximum over the reserve for that amount of pension. Correspondingly, it may not be so simple to make arrangements with the insurance company under an individual policy type plan, or under a plan where the contracts have been converted to annuities to cause the annuities being paid to the participant to be reduced. Many schemes have been invoked to meet this particular situation. One of the most common is to accumulate the amounts in excess of the sum which may be paid into the fund, and pay the reduced permitted pension to the participant subject to restriction. At a later time when the employer has placed the plan back in good graces by meeting full current costs, the sums withheld may be distributed to the participant or to his estate. It is not so easy, however, to resume the payment of the full current cost under the individual policy plan and obtain for the employer a deduction for the amount which he failed to put into the plan in prior years. It has been thought that “skipping a premium” on the several contracts of the employer results in the creation of a new past service base with respect to such employer. Under such conditions, a period of some eleven and one-third years is required to pay off the amount of the “premium skipped.” This raises the question as to what the status of an employee subject to the restriction of Mimeograph 5717 is during this period. It may be assumed that there is an ever increasing limit to the unrestricted maximum. In practice, however, the procedure followed has been to distribute to him the full amount of any payments due him, and to later run the risk of encountering a problem with the Treasury Department for so doing.

Similar problems can arise in the self-insured plan, or in the combination plan which employs ordinary life contracts and a side fund. Here again, failure to make contributions sufficient to prevent the unfunded
costs from rising can create a new past service base requiring the spread of the deduction over the more than eleven year period. Just when, however, is one to determine that the unfunded past service liability has been exceeded? If an employer contributes the minimum amount required by Treasury PS 57, i.e., no more than normal cost plus interest on the unfunded past service liability, it follows that the very next day the plan has violated the requirements of Treasury PS 57 because there is an unpaid portion of interest on the unfunded past service liability. Therefore, the test usually made to determine whether there has been a case where the unfunded past service liability has been exceeded is made on an annual valuation date selected by the actuary. Section 404, however, stipulates that a contribution made to a plan is deductible if made within the fiscal year, and in the case of an accrual basis taxpayer, a contribution is deductible if made within the time prescribed by law for filing a federal income tax return, including any extension thereof. For example, suppose that the valuation date selected by an actuary is the first day of an employer’s fiscal year. Under such circumstances, the Code would permit an individual employer to contribute some time within the ensuing fiscal year on a deductible basis plus the period of time afterward for filing the return (including permitted extensions). Yet, a strict reading of PS 57 would require an interpretation to the effect: (1) that the plan is in a state of bad grace, and is not qualified; (2) that interest earnings upon the fund are subject to tax and distributions from the fund not subject to the special provisions applying to distributions from qualified plans; and (3) that Mimeograph 5717 would have to be invoked. Should there be a later failure to contribute to the plan, it could be asserted that there should have been a full vesting of the fund as upon termination by applying the provisions of Revenue Ruling 55-186. Obviously, such results seem absurd. Accordingly, the Internal Revenue Service agents have usually held that a contribution made to the plan within the period of time prescribed by law for filing of a federal income tax return for a particular year relates back to the valuation date, and that the plan is still within a state of qualification.

**DISCOVERY: INFORMATION TO BE SUBMITTED TO THE TREASURY DEPARTMENT UPON TERMINATION OF A QUALIFIED PLAN**

The techniques of preventing discrimination by (a) controlling disbursements upon termination of a qualified plan, and (b) regulating the rate of contributions to a qualified plan during its lifetime so as to prevent its dying of starvation were discussed in previous parts of this ar-
ticle. Whether there has been a violation of the rules which apply to funding, and whether rules relating to restrictions on disbursement in the event of early termination apply, will appear when certain information is rendered to the Treasury Department upon the plan's termination.

There is comparatively little in the statute which deals with the termination of a pension plan. In 1938, section 165(a) of the Revenue Act was amended to require that an employer insert in his trust a positive statement to the effect that prior to the satisfaction of all the liabilities with respect to employees under the trust, no part of the corpus or income of the trust would revert to the employer. This provision has been carried forward into each succeeding Internal Revenue Code. The rule is simple and comparatively easy to understand. The other rules which have developed with respect to termination of the program are products of administrative determination.

In Treasury PS 56, published June 1946, the Service held that upon learning of termination of a plan, the trustee should notify the Commissioner of the termination before distribution of the assets. The reason given by the Commissioner in the ruling was that a program might qualify in one year but not in the next, and that, should it have failed to have qualified, a liability for taxes upon trust income might be owing for the years in which the trust did not qualify. This has placed an effective brake upon disbursements of assets pending a determination by the Treasury Department that the qualified status of the program has not been impaired by its termination. In June 1947, the Commissioner published PS 60 in which he detailed the information which would have to be submitted in the event that a plan terminated in order for a ruling to be rendered as to whether the plan's termination affected any prior ruling on qualification. The information currently required to be submitted under Revenue Procedure 56-12, Exhibit A, is virtually identical to that required to be submitted under PS 60. An examination of the information required to be filed by Revenue Procedure 56-12 provokes consideration of certain problems, tax and otherwise, which should not be overlooked when dealing with terminating or curtailing a qualified deferred payment profit-sharing plan or pension plan. An examination and discussion of each item required by the ruling is, therefore, helpful.

**Item 1, Exhibit A — Revenue Procedure 56-12**

Item 1, Exhibit A of Revenue Procedure 56-12 requires that there be furnished "the date as of which the plan is terminated or curtailed."

51. See pp. 668 to 672 supra of this text.
52. See Young, supra note 48.
As noted previously, a pension or profit-sharing plan is, for Treasury Department purposes, a permanent program. Pension plans seldom stipulate that they will terminate at a particular date. The exception to this occurs in certain labor negotiated pension plans.

As indicated earlier, the typical pension contract negotiated by the United Steelworkers of America is not an agreement to maintain a permanent pension plan, but rather is an agreement to provide that those employees who retire within the period specified by the contract will, for their lifetime, receive certain pension benefits. Often, liability is not limited to the funds put into the plan’s funding medium. Actually, because of the “double document” arrangement prevalent among employers who have negotiated such pension plans, termination for Treasury Department purposes does not occur at the end of the contract period. What does happen, however, is that the employer then normally renegotiates a new contract with the union, and then for qualification purposes amends his existing plan filed with the Treasury. The problems involved are not Treasury problems but rather contract problems, for it was held in New York City Omnibus Corp. v. Quill, that liability to continue the pension payments to those who retired during the contract term does not end when the contract term expires.

In the plan typically negotiated by the auto workers, the situation is different in that the plan is permanent and the rate and type of benefits are not subject to renegotiation during the term of the contract. Usually, these plans provide for giving notice of a demand to negotiate with respect to the plan at not less than a fixed number of days before the end of the contract term. Failure of either party to demand the opening of negotiations in this respect does not terminate the plan; instead, the plans provide that they continue on a “year-to-year” basis, subject to giving the requisite notice before the elapsed specified period of time occurring on any anniversary of the first date as of which the program could have been discontinued or modified had adequate timely notice been given. Usually, even though the plant at which the covered employees were employed closes down, the UAW will insist on the plan’s continuation until the expiration date fixed by contract. This permits employees to go upon the pension rolls as they satisfy the requirements for a pension. The consequence is a swelling of the census of retired lives immediately before the plan terminates.

Assuming that the assets of the trust did not, upon closing down of the plant, exceed the reserves for the pensions of those who had previously retired, it is obvious that the assets will not match the reserves for pensions of a larger number of retired lives. Thus, having kept the plan

54. See note 37 supra and accompanying text.
55. 297 N.Y. 852, 78 N.E.2d 867 (1948).
Young, Pension Plans

open has worked to the detriment of those who retired, but to the advantage of those who did not. From an equitable standpoint, the result is not as bad as it may seem, for it is not fair to reward one who retired first in time with an advantage over one who could have retired with the same age and service requirements, but did not.

Because pension programs are permanent, conscientious counsel may well raise the question as to the applicability of the Rule Against Perpetuities in this field. Actually, it is questionable whether the Rule Against Perpetuities applies at all, inasmuch as a large number of states have passed statutes which specifically exempt from the Rule Against Perpetuities applicable in that state any pension or profit-sharing fund or plan. Even in the absence of the specific statutory exemption, it has been stated that

as to pension trusts governed by laws that do not contain such provisions (referring to statutes exempting plans from the Rule Against Perpetuities), one should note that a trust may, without being invalid, continue beyond the period prescribed by the rule against perpetuities if the trustee or some other person or persons (such as the employer) has the power to terminate this trust within the period.\textsuperscript{66}

If there is any question as to the validity of the statutes which exempt pension and profit-sharing trusts from the application of the Rule Against Perpetuities, and of the inapplicability of the Rule Against Perpetuities because of the power of the employer to terminate the trust at any time, counsel would be well advised to consider at the establishment of the plan whether the rule is applicable. The rule is customarily phrased as: "no interest is good unless it must vest, if at all, not later than twenty-one years after some life in being at the creation of the interest."\textsuperscript{77} The phrase "if at all" has puzzled the law student who is required to understand the rule more than the practitioner who slavishly copies phrases to cope with the rule; it is customarily interpreted as meaning that an interest must vest within the period prescribed by the rule if it ever is to vest. It does not necessarily follow from the rule that an interest must vest. Hence, the Rule Against Perpetuities is not one which requires that a trust terminate within any particular period of time. Whether there is a rule which affects the duration of the trust is an open question. Therefore, since the rule does not require that a trust terminate within any particular period of time, the conditions under which a pension is to vest under a trust must be determined. Obviously, it will vest for such persons as reach normal retirement age, and obviously this will occur within the lifetime of those employees who are alive on the effective date of the plan's adoption. It is just as clear, however, that an individual could be

\textsuperscript{56} Patterson, op. cit. supra note 20, at 174.

\textsuperscript{57} Lauritzen, Perpetuities and Pension Trusts, 24 Taxes 519 (1946).
born one day after the adoption of the plan and hired many years later. Under the rule in *Leake v. Robinson*, the gift to the class would fail since the members of the class could not be definitely determined at the time that it was made. However, it has been argued by one scholar that to apply the rule in this manner is to ignore the basis of the formation of the rule. The rule, according to Mr. Lauritzen, was developed to prevent unreasonable restraints upon alienation. It is a rule developed to cope with a result under family trust law which the courts did not feel was socially desirable. There is ample evidence from other cases that where the socially undesirable results were not created, the courts would not apply the rule. Lauritzen cites such examples as business trusts, commercial mortgages, options to purchase leases, and charitable trusts.

Also, while Lauritzen cites several instances in which the court rejected the contention that the charitable trust exemption to the Rule Against Perpetuities applied to trusts is similar to pension trusts (such as one in which property was left to maintain the settlor's working men), these cases are really not good authority for the proposition that a pension trust is subject to the rule. Such an attempt to classify a pension trust within a recognized "pigeon-hole" ignores the fact that a pension trust does not fit into one of the older established "pigeon-holes," but into a newly fashioned one. So long as there is nothing socially undesirable about a pension plan — in fact there is legislative encouragement of it — and so long as there is statutory regulation of the pension trust, it should follow that the Rule Against Perpetuities will not be held to apply to such a trust where the rule is one of judicial interpretation. Obviously, where a state statute, such as in Ohio, stipulates the conditions under which interests must vest, a court may make reasonable exemptions from the application of the rule.

The rule must be watched, for in some older trusts clauses appear to the effect that the trust will terminate within twenty-one years after the last to die of certain employees named in the trust agreement. This raises the question as to whether it is possible to cut off an inchoate right to a vested interest in a share of the trust corpus should the employer amend the trust. In other words, the question is whether an employee could at some future time claim that it is beyond the power of the employer to eliminate such a clause from his plan by amendment. This has not been answered by the text authorities, but it would not seem likely that anyone would be so entitled. The interest can arise only upon the happening of a contingency, and provided the revision in the instrument will be made sometime in advance of the occurrence of the contingency, an individual

58. 2 Mer. 363, 35 Eng. Rep. 979 (Ch. 1817).
60. Id. at 526-27.
should not be allowed to argue that an employer is required to terminate the program so as to vest him with a share of the fund where the program would have socially desirable attributes.

Item 2, Exhibit A — Revenue Procedure 56-12

Item 2, Exhibit A requires that there be furnished a "statement setting forth the reason and circumstances relative to the (proposed) termination or curtailment."

It was noted in part 1 of this analysis\(^{61}\) that the Service had, in the early days of the modern era of pension planning, feared that plans would be set up as collapsible tax devices. As a result, the Regulations\(^{62}\) provide that while the employer may reserve the right to change or terminate the plan, 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 was not from its inception a bona fide program for the exclusive benefit of all employees. The consequences of a retroactive disallowance following failure to rebut the presumption of lack of permanence can be measured by the following language of a text book written on the subject of pensions in 1946.

If a plan is retroactively disapproved, the results may be drastic. The employer's contributions for all years not barred by the statute of limitations will be disallowed if the rights of the participants are forfeitable. Thus, deficiencies for at least three years could be assessed against the employer; and if gross income has been understated by 25%, five years would be open. Although the employer's contributions would still be deductible if the rights of the employees were nonforfeitable, provided, of course, that they constituted reasonable compensation, the employees would be taxable retroactively on such amounts for all years not barred by the statute of limitations. If they did not pay such tax, it is possible that the employer might be called on to pay it, since he would not have withheld tax, as required by the Current Tax Payment Act of 1943. Likewise, he may be called on to pay delinquent Social Security and unemployment taxes. Further, if the plan is retroactively disqualified, the employer may find himself declared guilty of having granted salary increases without approval and be involved in serious Salary and Wage Stabilization violations. Also the employer may not only lose the tax and interest on the funds contributed but the funds themselves which have been paid or applied irrevocably to the trust or the beneficiaries of the plan. For a while the Commissioner allowed payments contingent on approval and subject to recapture, but this privilege was withdrawn after the original approval under the Revenue Act of 1942. It is also to be noted that the two year carry-back and carry-forward provisions of the Code may assist in the continuance of pension plans.\(^{63}\)

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61. See p. 668 supra of this text.
63. CLARK, PROFIT SHARING AND PENSION PLANS (LAW AND TAXES) 125-26 (1946).
The severity of the penalty for failure to rebut the presumption of lack of bona fides was at once apparent to both the Service and the practitioner, and it became clear that certain hazards of doing business which were beyond the control of the employer and which would result in the termination of the qualified plan, ought to be considered differently from other circumstances which were within the control of the employer. Hence, in 1944, the Service published PS 29 which expanded the earlier version of section 1.401-(b) (2) of the Regulations. The Service stated that the ruling was not intended "to penalize the employer, who having set up a plan in good faith, abandons it after a few years because of insolvency or bankruptcy or because adverse business conditions beyond its control would make it unreasonably burdensome to continue the required payments under the plan." While there is a repetition of the concept that drastic circumstances must exist, there is nevertheless present a reassurance within the publication of this ruling that not every plan which ended after a short life would necessarily be attacked as a sham. Later, in August 1945, the Service stated in Treasury PS 52 that the term business necessity "has reference to adverse business conditions not within the control of the employer under which it is not possible to continue the plan." The Service stated in PS 52 that it would not look strictly upon those situations where the plan of one employer was terminated on the acquisition of its assets by a new corporation.

Mimeograph 6136 gave substantial breadth to the term business necessity. This ruling states, *inter alia*:

> [T]wo basic principals, however, affect the determination to be made, namely, the existence of a valid reason for the termination or change consistent with the assumption that the plan from its inception had been a bona fide program for the exclusive benefit of employees in general and complied with the requirements of 165(a) in other respects, not only at the adoption of the plan but also throughout its entire operation, inclusive of the termination.

The reader will find it interesting to note that in a matter of a few months, the Service had progressed in its published philosophy from the extreme point of requiring proof of drastic business necessity, to the softer position of demanding proof of a valid business reason for termination. Some examples stated as being valid business reasons were, "bankruptcy, insolvency, change of ownership in an arms length transaction, a bona fide and substantial change of stock holdings and management, and financial inability to continue meeting the cost of the plan."

At the time Mimeograph 6136 was issued, the Service maintained that in order for a profit-sharing plan to qualify, it must provide a for-

64. 1947-1 CUM. BULL. 58.
65. Id. at 59. (Emphasis added.)
formula committing the employer in advance to contribute a share of his profits to the plan. This raises the question as to whether there is an interrelationship between this rule and the "valid business reason" rule. It is obvious that a rule requiring a predetermined formula may be circumvented by the mere device of establishing a plan with a stipulated formula, and then amending it yearly or at other frequent intervals so as to alter the amount of profit being placed in the plan. Several examples were set forth in Mimeograph 6136 as to conditions which the Service would or would not construe as presenting a valid business reason for terminating a plan. As to those not presenting a valid business reason the Service indicated that it would regard the making of an amendment which would reduce the percentage of profit to be contributed as a curtailment of a program sufficient to warrant a determination that the presumption of lack of bona fides had not been overcome. The problem arising after such a determination was presented to the court in E. R. Wagner Mfg. Co. The Tax Court took the position that the revision in the formula could be made inasmuch as the revised formula provided for a contribution of sufficient dimension to achieve the social purposes designed to be encouraged by the statute. The Lincoln Electric case was cited with approval by the court. It is to be noted that the court's reasoning is very similar to that presented in the Lincoln Electric decision, namely, that one must look to the transaction in question to determine if the statutory scheme is being fulfilled. Of course, it is one thing to look at a plan that is continuing and say that, as modified but continuing even though curtailed, it fits into the pattern contemplated by Congress, and it is another to look at a terminated plan and say that its termination does not impair the prior determination of qualification because during its lifetime, it fulfilled the statutory scheme. In other words, one would expect that a higher standard would be required in proving that there is a valid business reason to terminate a plan than would be required when the transaction in question is an amendment, reducing or otherwise curtailing benefits where the purported justification for the action is allegedly that the purposes contemplated by Congress were in fact achieved. In practice, this has proved to be the case.

The requirement of proving bona fides is related to the theory developed within the Treasury Department that the plans being adopted during World War II were merely surreptitious schemes to escape the impact of excess profits tax. Both Mimeograph 6136 and the E. R. Wagner case refer to the reduction, at the time the amendment was made, of the amount of tax to be levied on corporate income. It is obvious that the higher the corporate income tax, the lower the net cost of a deductible contribution to the employer. The answer to this philosophy

is that the law permits financing of these plans at a rate that is convenient to the taxpayer regardless of the tax rate at the time of the contribution. Contrary to the generally accepted rule in American tax law that deductions must fall in a particular year without being controlled in their size by the whim of the taxpayer, there appears in the pension field, statutory permission designed to encourage the corporate taxpayer to take his deductions with a relative degree of convenience in order to foster a socially desirable scheme of deferred retirement programming. A few examples are illustrative of this point.

(a) Section 404(a)(1) gives three⁶⁷ alternatives for claiming a deduction. Nothing in the statute prohibits the taxpayer from shifting from one of the methods to the other in different years, although, as a matter of practice, this is unusual. As a matter of fact, when the Commissioner sought to establish that the last of the three alternatives superimposed a maximum on the amount claimable under either of the other two, his contention was regarded without merit in the courts.⁶⁸

(b) Use of the open-end mortgage method of financing a pension plan is permitted within the minimum fixed by Treasury PS 57 and the maximum allowed by section 404(a)(1)(C). By contributing the maximum in a period of high tax and little or nothing in a period of low tax, there is a device interrelating ruling and statute for timing the contribution to the ability and need to pay which could be perverted into timing the contribution to the tax rate.

(c) Section 404(a)(3)(A) permits a sponsoring employer who has contributed less than 15 per cent of his payroll to a profit-sharing plan in one year to contribute in the next year, over and above the normal 15 per cent allotment for that year, an amount equal to the excess of 15 per cent of the payroll of the covered employees over the amount contributed in the next preceding taxable year. Here too, there is a device which could be perverted into timing contribution to tax rate.

That possibilities of abuse exist should not result in a presumption that there is abuse. A high tax rate in a time of business prosperity is but one facet of the environment of the times; also present is the enthusiasm of business men that "good times" will continue. Therefore, a re-

⁶⁷ The deduction may be claimed under INT. REV. CODE of 1954 §§ 404(a)(1)(A), (B), or (C) [hereinafter cited as CODE §] suggesting three alternatives. In practice, they are customarily so regarded. Technically, however, CODE § 404(a)(1)(B) is regarded as an extended limitation of CODE § 404(a)(1)(A). Cf. Reg. § 1.404(a)-5(b) (1956).

duction in tax rates in and of itself should not be presumed to be the reason for reduction in benefits under a qualified plan, but rather as one of the elements to determine when there is a valid business reason for modifying or terminating it. A statement to the effect that "a plan which is set up during years of high tax rates and is abandoned within a few years without a valid business reason when profits fall off is not within the intent of section 401(a)" is too bald. As a matter of fact, an argument can be made that a reduction in tax rates presents a valid business reason for curtailing benefits under a program.

The 1941 amendments to section 165(a) of the 1939 Internal Revenue Code had been preceded by a congressional study. Senate Resolution 215 of the 75th Congress, proposed by Senator Vandenberg of Michigan, authorized the study of the pension and profit-sharing plans then current. The study attempted to determine what encouragement the federal government could give to the adoption of pension and profit-sharing plans, including "the grant of compensatory tax exemptions and tax awards when profit-sharing is voluntarily established." The Committee concluded that it was not practical to apply incentive taxation to the profit-sharing motive. However, it cannot be denied that the tax rates which existed during World War II and which continued in the post war period have operated as a strong inducement to encourage high paid executives in control of the destinies of corporations to adopt pension plans.

Although one may deplore the selfish motive which has encouraged the adoption of thousands of retirement programs, the fact is that they have been adopted and that Congress has not seen fit to make any change in the rules even though it could have done so when it revised the 1954 Internal Revenue Code and had before it several proposals for making modifications that would have severely limited this inducement. Therefore, a minimization of tax rates should justify a revised attitude in maintaining the plan on its old basis. At this point, "valid business reason" and "fulfillment of social objective" are theories that take different routes.

The lenient administrative attitude toward curtailment has not prevailed when dealing with plan terminations. However, while the court has upheld the Commissioner's requirement that qualifica-

71. S. REP. No. 610, supra note 70, at 6.
73. A statement that private benefit decreases are justified by social security benefit increases has often been accepted by the Internal Revenue Service as a valid business reason for curtailment.
tion may be maintained only upon establishment of a valid business reason, the court has found that each questioned transaction was affected with a valid business reason. Other valid business reasons accepted by the courts for termination are: (a) the taxpayer's erroneous belief at the inception of a plan of the position which the Service had of the taxpayer's right to terminate or curtail a plan, and (b) failure of the plan to accomplish the objectives for which it was adopted. The few cases decided have indicated that the courts do not accept the original strict attitude of the Service. However, these cases, while unimportant in themselves, are significant because the opinions are demonstrative of the attitude which the judiciary is likely to take of the problem.

In Ingram v. Riddell, the pension plan which was the subject of litigation was funded by individual, level premium policies. Ninety per cent of the premium was paid by the employer, and the balance by the employees. Faced with a fifty per cent reduction in profits five years after it had adopted the plan, the employer sought to amend the plan by increasing the employee contribution. Management had been led to believe by the insurance men who had persuaded the employer to institute the plan in 1943 that such a revision was acceptable to the Service. On being advised that the government would contest the revision, the company terminated the plan. Litigation followed; the court held that the plan was terminated for business necessity and that the original qualified status had not been lost. The court separated its conclusions of law from its findings of fact; hence, the opinion does not interrelate the facts to the conclusion. However, one may conjecture: (a) that five years was sufficient to minimize the standards of proof required to show a valid business reason inasmuch as the court's "conclusions of law" state that the plan was in operation for more than a few years, and upholds the Regulations pertaining to presumptions of lack of bona fides because of failure to be in existence more than a few years; (b) that misunderstanding of the legal rules as to rights of curtailment at the time of the program's adoption influences the standards to be employed in determining whether there is a "business necessity" when the plan terminates; and/or (c) that there was a "business necessity" without reference to the

74. In other areas of tax law, the Internal Revenue Service has adopted the test of "business purpose" to determine whether a transaction is legitimate. For example, a corporate reorganization does not qualify as a tax reorganization within the scope of Code § 368, even though it meets the literal tests of the statute, unless the transaction has a valid business purpose. See Bazley v. Commissioner, 331 U.S. 737 (1947); Adams v. Commissioner, 331 U.S. 737 (1947); Gregory v. Helvering, 293 U.S. 465 (1935).
76. Cf. Min. 6136, pt. 5, 1947-I Cum. Bull. 58, 60 which provides: "An amendment requiring employee contributions to provide the same benefits which previously were provided exclusively by employer contributions results in a curtailment. The mere fact that benefits are reduced does not necessarily render the amendment . . . objectionable."
misunderstanding where a plan had been in existence for more than a few years.

On two other occasions the courts considered the "business necessity" rule. In Blume Knitwear, Inc., 77 the taxpayer had adopted a deferred payment profit-sharing plan during World War II to augment the payment of current compensation since increases in salaries were prohibited by government action. Publications of the Salary Stabilization Unit indicated that the method of disbursement delineated in the plan (payment in a series of installments after conclusion of the War) would be acceptable, but subsequently, after adoption of the plan and payment of the initial contribution, the Salary Stabilization Unit changed its position and refused to approve the stipulated method of disbursing in installments. Although the plan could have been amended to comply with the position of the Salary Stabilization Unit, the employees, according to the testimony of the president of the company, would have been unwilling to accept the plan. Accordingly, the company exercised its reserved rights under the plan and discontinued the making of contributions. Later, to obtain Internal Revenue approval of the program, presumably for purposes of claiming a deduction for the contributions already made, amendments, including those to implement the thirty per cent rule, were made. The Internal Revenue, not yet apprised of the discontinuance, issued a favorable determination letter reversing a prior unfavorable determination. On learning of the discontinuance, the Service took the view that it had been deceived by the lack of disclosure, and withdrew the approval letter. A tone of wounded indignation permeates portions of the revocation letter which are reprinted in the opinion. The court stated that even granting the government's position that the plan did not terminate for business necessity, the plan had nevertheless been a bona fide program established for the exclusive benefit of the employees and was terminated only when the purpose envisaged by it, i.e., compensatory relief to overcome salary "freezes" imposed by the government, could not be fulfilled. 78

77. 9 T.C. 1179 (1947).
78. In P.S. No. 68, published July 3, 1951, the Service held that a plan adopted during the Korean crisis could provide that payments thereto would be recovered if the plan failed to meet the Wage Stabilization requirements under the Defense Production Act of 1950. In P.S. No. 47, published February 21, 1945, after the adoption of the Blume Knitwear plan, the Service ruled that it would no longer accept plans which contained clauses that contributions were recoverable if a plan failed to meet approval. Thus, in the Blume Knitwear case, the taxpayer could have, under procedures then acceptable, conditioned his payment on government approval. Perhaps the obdurate position of the Internal Revenue is understandable from that point of view.

Newly adopted plans may now again have clauses permitting reversion of employer contributions should the plan fail to qualify. See Rev. Rul. 59-309, 1959-2 Cum. Bull. 117. The issue has been litigated in the courts and the taxpayers' position sustained. See, e.g., Meldrum & Fewsmith, Inc., 20 T.C. 790 (1953), acq., 1954-2 Cum. Bull. 5. Therefore, Treasury P.S. No. 47 may be considered effectively overruled. The rule now seems to be that where the contingency for reversion of a payment is within the control of the government,
This rather lengthy description of a relatively unimportant case is presented only to indicate again that the Tax Court has not always accepted the “business necessity” rule as an absolute. The case illustrates that abandonment within a few years after adoption without proof of business necessity merely creates the presumption that the program was not bona fide, but the presumption is rebuttable and the courts will accept evidence of failure of the program to meet its objectives as proof of the bona fides. This, it should be noted, is not the same as stating that failure to meet the objectives is a “valid business reason.” Such a rule was to await the case of *Kane Chevrolet Co.*79 There, the plan involved was terminated about one year after it had been adopted. The reason given the government was that the plan failed to accomplish the objectives for which it had been adopted, namely, reduction in labor turnover and employee satisfaction. Indeed, the opinion states that employees were more anxious to receive immediate compensation than pensions. The Service claimed that the program was not entitled to qualification since the taxpayer had failed to show business necessity for termination. Citing *Mimeograph 6136*, Judge Opper, who also rendered the opinion in the *Blume Knitwear* case, noted that “business necessity” is a phrase synonymous with “valid business reason,” and held that failure to meet objectives is a valid business reason to terminate a plan.

To summarize, a plan terminated within a few years after its adoption must establish that it started as a bona fide program for employees. The presumption that it was not bona fide may be rebutted by proof of a valid business reason for termination. The courts accept as proof of a valid business reason: (a) erroneous belief of the Service’s position on the subject at the inception of the plan, and (b) failure of the plan to accomplish the objectives for which it was adopted. Casting doubt on the doctrine that a “valid business reason” must be proved to rebut the presumption of lack of bona fides, are the cases which have held that evidence of the plan’s failure to meet its objectives will establish bona fides, if not business necessity, and the holding that one must look to see whether the plan attained or approached attainment of any of the objectives of Congress in establishing the basis for tax deductible programs under section 401(a) of the Internal Revenue Code. The courts have

and all steps taken by the taxpayer have been to plan reversion beyond the control of the taxpayer, the plan is final enough to qualify.

*Quaere:* What of an amendment adopted subject to approval of the Internal Revenue Service? The reasoning of the cases overruling P.S. No. 47 would indicate that in such a situation the placing of reversion within the control of the government and not the taxpayer would also permit qualification. The question also arises as to whether the deduction would be allowed if the determination letter stipulating approval is not received before the close of the taxable year. *Cf.* Reg. § 1.404(a)-1(c), which provides that all facts necessary to perfect an accrual must be established before year end. To date, the issue has not been raised.

79. 32 T.C. 596 (1959).
failed to confirm the Service's strict attitude which waned as the excess profits tax was removed, and as the Service abandoned its original position of requiring a predetermined formula.

**Item 3, Exhibit A — Revenue Procedure 56-12**

Item 3, Exhibit A of Revenue Procedure 56-12 requires:

A tabulation in columnar form showing the information specified below with respect to each of the twenty-five highest paid employees at the time of termination or curtailment (or, in case of a proposed termination or curtailment at the most recent anniversary of the plan) listed in the order of their compensation, and for all other employees as a group (showing the number in such group), covered by the plan:

(a) Name.
(b) Whether an officer.
(c) Percentage of each class of stock owned directly or indirectly by the employee or members of his family.
(d) Data, separately for the year in which the plan is terminated or curtailed and for each of the preceding years of the plan's operation (not in excess of 5, unless required) with respect to:
   (i) Total compensation, other than deferred compensation.
   (ii) Employer's contribution.
   (iii) Employee's share in forfeitures.
   (iv) Employee's contributions.
(e) Total for each of the columns under (d) above, for each year.
(f) Summary columns showing in aggregate (totalled horizontally) for all years, with respect to each of the employees listed and all others, data similar to the items called for under (d) above.
(g) A final column showing the total value of benefits distributed or to be distributed to each of the twenty-five highest paid employees and to all others.\(^8\)

The information required above should be compared with the information required to be submitted upon qualifying a plan when claiming tax deductions under Regulation 1.404(a)-2(a)(3). That Regulation requires that a schedule be submitted, customarily referred to as the twenty-five highest schedule, listing the information (similar to that listed above) for the first taxable year with respect to which a deduction is claimed. Once that schedule is submitted it is not required to be submitted again pursuant to Regulation 1.404(a)-(2)(b)(2) for any subsequent taxable year, except to the extent of showing in the tabulation "such information with respect to the employees who, at any time in the taxable year, own, directly or indirectly, more than five per cent of the voting stock, considering stock so owned by an individual's spouse or minor lineal descendants as owned by the individual for this purpose."

Furthermore, Regulation 1.404(a)-(2)(b)(2) stipulates that the District Director may request that the information required by Regulation

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1.404(a)-2(a)(3) shall be filed more frequently. That Regulation also contains the statement that the full schedule need not be filed "so long as the plan and the method of basis of allocation have not changed." Within the scope of these reserve powers, the District Directors have required the filing of schedules whenever amendments have been made to plans. To some extent the filing of this information has been limited to times when an amendment has been filed for the reason that the information required by the schedule is posted from the data submitted by the taxpayer to a form used by the Service and known as the 517-A Form. That form requires the submission of information with respect to the five highest paid employees and consolidated information as to the twenty-five highest paid employees. It is to be noted that section 1.404(a)-2(e) permits the District Director to waive the filing of the information required if he finds it unnecessary in a particular case. For this reason, the District Director has frequently waived the filing of the information required by the twenty-five highest schedule in union negotiated programs. The District Directors have also frequently waived the filing of this information in salaried pension plans in which the benefit is computed at some minimal rate amounting to less than $125 per year. For the same reasons, the several District Directors have normally waived the filing of the detailed, lengthy schedule required by Item 3, Exhibit A of Revenue Procedure 56-12, in instances where the plans were of the union negotiated type, or were salaried programs having minimal benefits.

Nevertheless, because annual filing of the schedule is not required, and properly so, the assembling of the data sufficient to prepare the consolidated schedule for a five year period for purposes of Item 3, Exhibit A of Revenue Procedure 56-12 is tedious and time consuming to the taxpayer and his agent. Because of the District Directors' broad power to waive filing of the information, it is desirable to gain an insight into the original reasoning of the Service for requiring the information to be filed, and from this to determine whether it is proper to request that filing of the consolidated schedule be waived when the plan terminates. A reproduction of the twenty-five highest schedule which is filed upon securing qualification of the plan appears in an appendix to this article. The following discussion is in reference to the column numbers in that schedule.

Columns 1 to 6.—The statute stipulates that a plan shall not discriminate in favor of stockholders, supervisory employees, or highly compensated employees. Therefore, the information as to whether the employee is an officer, the percentage of stock which he owns, and whether his principal duties consist in supervising the work of other employees will help determine whether the program has been weighted in favor
of the group in favor of whom discrimination may not exist pursuant to the law. Some of the questions are not always simple to answer.

Column 2.—Whether or not a person is a corporate officer can be determined by an objective test. However, questions often arise as to whether an assistant secretary is an officer. Here, a subjective test may have to be employed in place of an objective test based upon the title in determining whether the individual has sufficient responsibilities within an organization to be classified as an officer. Usually, the traditional corporate officers — President, Vice President, Secretary and Treasurer — will be the only ones who will be indicated as being officers upon the form.

Column 3.—Regulation 1.404(e)-2(b)(2) indicates that the class of stock owned directly by the employee or members of his family refers to the stock owned by the individual’s spouse and minor lineal descendants. It is probable that stock of the company held in a private trust of which he is the settlor is likewise the stock owned indirectly by the family.

Column 4.—In answering the question as to whether the principal duties of the individual consist in supervising the work of other employees, a practical yardstick has been employed in holding that one’s principal duties consist in supervising the work of other persons if one-half of the time of the individual is actually spent in a supervisory capacity. Merely because one has the right to direct the activities of others does not mean that his principal duties are supervisory in nature.

Column 7: Inserting the Information.—Entering the information upon the form as to the annual compensation of the individual involved often causes problems since the Regulation requires that there be inserted the compensation paid or accrued for the taxable year. It is to be noted that column 9 requires that sub-columns be filled in to indicate the amount of pension cost or share of profit allocated to the participant in that year. A conscientious agent will frequently check the indicated share of profit or amount of expected pension under column 11 against the compensation and against the formula in the plan to determine whether the amount is correct. The trouble arises from the fact that plans frequently employ, for administrative convenience, a definition of the term “compensation” to determine the amount of pension or share of profit contributed that differs substantially from the amount of compensation paid within the taxable year. For example, it is not unusual to find that the rate of pay in effect on a particular date during the year is annualized (multiplied by 12 if a monthly rate, 52 if a weekly rate, or 2080 if an hourly rate) in order to determine the compensation for plan purposes. In other instances, particularly in those
cases involving salesmen, an average of earnings over a three or five year period is not uncommon because of wide fluctuations. Moreover, column 7(i) requires that consolidated basic plus overtime compensation be inserted, though the plan may compute benefits on basic compensation alone, again causing an unexplained deviation. Under such circumstances, it is advisable to insert an extra column on the form that is submitted when seeking initial qualification of the plan to demonstrate the amounts from which the computations are made.

**Column 7: Did the Plan Cover the Highly Compensated?**—When the Service reviews the plan upon termination to determine whether it has, within the language of Mimeograph 6136, met the qualification requirements during its lifetime, a panoramic view is spread before the agent by the schedule for five years required by Item 3, Exhibit A, Revenue Procedure 56-12 to determine whether in the five year period, the program has resulted in the inclusion of persons who are officers, shareholders, supervisors, or highly compensated employees.

At this point, it is well to consider what the Service has in mind in determining whether the program discriminates in favor of “highly compensated” employees. It is to be noted that the statute provides that a plan shall not be considered to discriminate in favor of officers, shareholders, supervisors or highly compensated employees merely because it covers salaried or clerical employees. Inasmuch as the disjunctive “or” is used in the statute instead of the conjunctive “and,” it is obvious that a plan could cover salaried employees without covering clerical employees. In the Congressional Reports, the Senate indicated that such a provision was designed to permit qualification so long as the program did not result in discrimination. In referring to this provision, Regulation 1.401-1(b)(3) clouds the issue with the language that “this does not mean that a plan containing provisions may not be discriminatory in actual operation.”

Legislative history, as noted in the earlier discussion of Mimeograph 5717, supports the theory that a comparison of pay scales of the employees included in the plan with the pay scales of the group excluded from the plan is not an exclusive test in the determination of whether the plan discriminates in favor of the highly compensated. The 1942 Bill amending section 165 of the 1939 Internal Revenue Code stated that a plan could not qualify if it discriminated in favor of employees whose compensation was greater than that of other employees. The statute as passed provides that a program may not discriminate in favor of highly compensated employees. This shift from the comparative term, “greater,” to the adverb, “highly,” is significant. Furthermore, it is common knowledge that salaried personnel customarily earn more than non-salaried...
Studies prepared by the Wharton School of Business for the U.S. Department of Labor in 1950 demonstrate this. There are therefore two tests, both subjective: (1) whether the individuals covered by the plan are "highly" compensated according to the contemporary standards of the community within which they draw compensation, or (2) whether they are "highly" compensated as determined by comparing the pay scales of persons excluded and included in the plan. More weight should be given, because of the legislative history, to the contemporary standards of the community in which the compensation is received than to the intra-company pay scale test, but both have a significant effect upon the decision.

It should be noted, however, that although the plan may have originally qualified, large rates of turnover among lower paid employees may have resulted during some of the years in question in the maintenance of a plan for supervisory personnel, shareholders, officers, and highly compensated employees. The consolidated five year schedule will now apprise the Service of facts about which it may not have known, except with respect to five per cent stockholders. A determination may be made from the data that by operation of facts over which the taxpayer has had no control, the program has become discriminatory as that concept is employed by the Service. The Ryan School case held that a plan had not become discriminatory because of the change in facts over which the taxpayer had had no control. In that case, a program that started out with a large number of employees, ended with only a few, and most of these were shareholders or officers. Before extending the Ryan School doctrine too far, it should be noted that in that case there were no additional contributions made once the fact pattern had changed. If a taxpayer finds that his plan covers only a few people within the group, but he nevertheless continues to make contributions with respect to those people, it would seem arguable, from the Service's standpoint, that the Ryan School doctrine is inapplicable. The taxpayer is then faced with a dilemma. If the plan is terminated, and the termination occurs within a few years after adoption of the program, the taxpayer must come forward and prove that business necessity was the cause of his action and that the program was bona fide; if he fails to discontinue, any further contributions are at his peril, leaving in the hands of the Service a Sword of Damocles that may fall at anytime on his purported right to claim the

81. For judicial recognition of this commonly known fact see H.S.D. Co. v. Kavanagh, 191 F.2d 831, 840 n.5 (6th Cir. 1951) wherein it is stated: "but being hourly employees, [their compensation] was certainly much less than the income of the executive employees."
82. Mir. 6136, para. 1, 1947-1 CUM. BULL. 58.
83. 24 T.C. 127 (1955).
deduction. At this juncture the taxpayer must take his choice; he can either resubmit for re-qualification, or let the matter ride.

Column 7: Unreasonable Compensation.—Aside from the question which arises as to whether the program in fact covered a non-discriminatory group during the period of time covered under the schedule required by Item 3, Exhibit A it is quite probable that the agents will check the employer's contributions in column 9 at the inception of the plan, and on the consolidated schedule pursuant to paragraph 3 (d)(ii). The purpose of this check is to determine, on behalf of each employee, whether that contribution, when combined with the compensation under column 7 paid to the employee in each of the years involved, was an unreasonable amount of compensation so as not to be deductible as an ordinary and necessary business expense. Some background may explain the problem.

Section 23(p) of the Internal Revenue Code of 1939, as amended, read in part as follows:

If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing or annuity plan, or if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such contributions or compensation shall not be deductible under subsection (a) but shall be deductible, if deductible under subsection (a), without regard to this subsection, under this subsection but only to the following extent ....

This very confusing language which was cited by the Republican candidate for president during the 1944 campaign as an example of the unnecessary extreme to which tax law language could go, means simply that "employer contributions must fall within a class of expense deductible under section 23(a), and such contributions are allowable deductions only to the extent provided in section 23(p)." To have been allowable as deductions under section 23(a), the taxpayer was required to establish that employer contributions under the plan constituted reasonable compensation for personal services, for section 23(a) provided that "all ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered," would be allowed as a deduction in computing net income. Dean Griswold of Harvard University has argued that the history of the statute shows that it should not properly be construed as authorizing the Commissioner to limit the deduction to salaries actually paid, but,

84. Rev. Proc. 56-12, 1956-1 CUM. BULL. 1034.
on the contrary, the phrase was intended to allow the deduction of a reasonable allowance for salaries even though they had not actually been paid. The Department's attitude toward this contention, and indeed that of the courts, can be most politely expressed as treating it as though it does not exist. In general, the question of the propriety of the deduction of a reasonable allowance for salaries is most commonly raised in connection with closely held corporations where salaries were paid to stockholder employees or stockholder officers or relatives or to friends. It has been stated that

in determining whether salaries are reasonable a great many factors are taken into account. Among the more important are: the nature of the services rendered; the salaries paid in prior years for the same type of work; whether the salary is on a contingent basis — a larger amount may be reasonable if the compensation is contingent; the amount the employee could have obtained from another employer for the same work. If large salaries are paid to employees or officers who are also stockholders, and if the salaries bear a close relationship to the amount of stock owned, the Commissioner can be expected to question a part of the salary payments on the ground that they represent a concealed distribution of dividends.

Prior to the 1942 amendments of the Internal Revenue Code, nondiscrimination was not a criterion for qualifying a tax-exempt program. If a contribution made to a program constituted reasonable compensation, it was deductible. The influence of this concept probably induced an early writer on the subject of pension plans to comment in 1946 that it was anticipated that most of the questions "arising as to the deductibility of contributions to the employees' trusts will pertain to the requirement of reasonableness." This point was illustrated by a case arising under the law existing before 1942 where it had been held that the salary and bonus were reasonable, but the annuity premium expended in 1941 under the subject plan was excessive, and disallowed.

89. This is not always the case. Cf. Patton v. Commissioner, 168 F.2d 28 (6th Cir. 1948) wherein a large deduction was claimed for salaries paid to a valuable employee whose duties were of a routine office nature.

90. STANLEY & KILCULLEN, FEDERAL INCOME TAX 65 (3d ed. 1955). Compare the statement in Reg. § 1.401-1(b) (3) that "if the Plan is so designed as to amount to a subterfuge for the distribution of profits to shareholders, it will not qualify as a plan for the exclusive benefit of employees even though other employees who were not shareholders are also included under the plan."

Other factors to consider are: (1) presumption of reasonableness from the board of approval—Toledo Grain & Milling Co. v. Commissioner, 62 F.2d 171 (6th Cir. 1932); (2) increase in cost of living—Roth Office Equip. Co. v. Gallagher, 172 F.2d 452 (6th Cir. 1949); (3) increase in sales and profits—Brown-Forman Distillers Corp. v. United States, 132 F. Supp. 711 (Ct. Cl. 1955); and (4) uniqueness of talent—Brown-Forman Distillers Corp. v. United States, supra.


92. CLARK, op. cit. supra note 63, at 188-93.

Litigated cases on the subject under the Code subsequent to the 1942 amendments appear to be rare. The author has been able to find but one, namely, *Charles E. Smith & Sons Co. v. Commissioner,* 94 a per curiam opinion of the Sixth Circuit Court of Appeals, in which the court found that the compensation itself was unreasonable without regard to the pension contribution. However, the court went on to say, quite logically, that the pension contribution on behalf of the officer under attack was likewise not deductible. 95 The mere absence or rarity of cases should not be read as a barometer indicating the absence of a storm, for as was stated by one writer:

The litigated cases [on unreasonable compensation generally] numerous as they are, undoubtedly represent only a tiny fraction of the disputes [involving unreasonable compensation] since the factual nature of the question and the presumption of correctness enjoyed by the Commissioner both make for settlements to avoid the cost and the uncertainty of law suits. 96

In part, a pension reflects an award for prior services rendered. Statutorily, both sections 404(a)(1)(A) and 404(a)(1)(C) reflect congressional approval of a deduction taken for payments with respect to past services. Case-wise, the leading decision of *Lucas v. Ox Fibre Brush Co.,* 97 states that "the statute does not require that services should be actually rendered during the taxable year, but that payments therefor shall be proper expenses paid or incurred during the taxable year." Section 23(p), as amended in 1942, limited, and its successor, section 404, limits the extent to which the deduction can be taken for contributions with respect to past services. Probably in recognition of the *Ox Fibre* case, Regulation section 1.404(a)-(1)(b) states:

What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year. Thus, a contribution which is in the nature of additional compensation for services performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reason-

94. 184 F.2d 1011 (6th Cir. 1950).
95. Deductions were not allowed for the balance of the contributions for 1942 because (1) failure of the taxpayer to sustain his burden of showing that the contributions related to contributions deductible under *INT. REV. CODE OF 1939,* § 23(p), 53 Stat. 37 (now *INT. REV. CODE OF 1954,* § 404), as it existed prior to the 1942 amendment; and (2) for 1943, for failure to sustain the burden of proving that the balance was unreasonable for the others.
96. BITTNER, FEDERAL INCOME TAXATION 160 (Prelim. ed. 1953).
97. 281 U.S. 115 (1930).
able allowance for all services rendered by the employee by the end of the current year.88

The Ox Fibre case is judicial, and Regulation section 1.404(a)-(1)(b) is administrative authority for the proposition that one does not necessarily conclude or presume that the combined immediate compensation for a year and pension cost and/or profit-sharing share for the same year add up to a sum that is unreasonable compensation for such year. Both are authority for the proposition that pension payments made in a year for services not rendered in that year must be given reduced weight before concluding that the payment when added to immediate income is unreasonable. The Regulation does not stipulate the criteria to be employed in determining the method of attributing the payment to prior service. Actuarial techniques could be employed, and the arithmetic technique of averaging the total payments over the full period of employment to determine the cost per year also suggests itself. In the latter case, showing reasonableness over all years might require the production of further evidence for prior years.90 This issue may arise if the pension plan terminates shortly after it has been amended to increase benefits. If one of the twenty-five highest paid participants is within a few years of retirement age when the plan terminates, the cost applicable to him will show up on the termination schedule as being very high, and while Treasury PS 50 provisions will probably have been incorporated in the plan, the issue of unreasonable compensation may nevertheless arise. Some method of determining what part of the payment applies to prior service must then be determined, the arithmetic averaging technique being the most simple. If a cost per year is developed, and the “related back annual cost” is added to the annual compensation for a year, a unique method of establishing reasonableness is suggested. In rebuttal to a Service challenge to the reasonableness of compensation, the courts have given much weight to earlier Service approval of deduction of a like or smaller amount of compensation.100

The figures in the following table bear no relationship to any actual situation; the arithmetic device of dividing the aggregate pension cost by sixteen years of employment is arbitrary, and the table is presented purely to facilitate the explanation of a theory. It is assumed that $45,000 will be allowed as reasonable; if so, the “related back” rule indicates that the

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90. Prior to publication of Rev. Proc. 56-12, 1956-1 CUM. BULL. 1029, the rules for termination were set forth in Rev. Rul. 32, 1953-1 CUM. BULL. 265 which provided, as did its predecessor P.S. No. 60 that information on the twenty-five highest schedule at termination should cover all years of the plan’s operation.
annual compensation plus "related back cost" for the years before 1950 is
less than the allowable as reasonable immediate compensation for 1950 and
1951. The issue then relates to the pension cost for 1950 and 1951,
\textit{i.e.}, whether compensation of $48,590 is unreasonable, and the possible
counter charge of the Service that if related back to years before 1943,
particularly when related to the depression years, the amount is not really
reasonable for those years. The answer to that position is that the social
aspects of section 401 must be considered. Many believe that it is socially
desirable to provide a worker with a pension that approximates a relation-
ship to his final wage. Indeed, the integration rules\textsuperscript{101} in the Treasury's
Regulations permit the benefit to be based on the highest consecutive
five year average, and the published position on "final pay" plans indi-
cates that discrimination is minimized when the benefit is based on a final
five year average.\textsuperscript{102} If the benefit is socially desirable, if it is not dis-
criminatory, if the cost can be pro-rated back to prior years under Treasury
rules, and when so pro-rated produces an amount which when added
to immediate compensation is less than an amount allowed as a deduction,
it is submitted that the deduction for the addition in cases for 1950 and
1951 in the above table ought to be allowed, for the amount under
these circumstances is reasonable.

\textit{Column 9: Determination of Amount Applicable to Participant.—}
In a program where a level premium funding method is employed to deter-
mine costs, it is relatively simple to insert in column 9 the amount contrib-

\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{Year} & \textbf{Annual Compensation} & \textbf{Pension Contribution} & \textbf{Related Back Pension Cost} & \textbf{Col. 2 Plus Column 4} \\
& \textbf{Deducted Without Challenge} & \textbf{For Year} & & \\
\hline
1936 & $8,000 & $0 & $3,590 & $11,590 \\
1937 & 9,000 & 0 & 3,590 & 12,590 \\
1938 & 10,000 & 0 & 3,590 & 13,590 \\
1939 & 12,000 & 0 & 3,590 & 15,590 \\
1940 & 15,000 & 0 & 3,590 & 18,590 \\
1941 & 18,000 & 0 & 3,590 & 21,590 \\
1942 & 20,000 & 0 & 3,590 & 23,590 \\
1943 & 24,000 & 0 & 3,590 & 27,590 \\
1944 & 30,000 & 2,000 & 3,590 & 33,590 \\
1945 & 30,000 & 2,000 & 3,590 & 33,590 \\
1946 & 32,000 & 3,800 & 3,590 & 35,590 \\
1947 & 35,000 & 4,800 & 3,590 & 38,590 \\
1948 & 38,000 & 7,500 & 3,590 & 41,590 \\
1949 & 38,000 & 7,500 & 3,590 & 41,590 \\
1950 & 45,000 & 15,000 & 3,590 & 48,590 \\
1951 & 45,000 & 15,000 & 3,590 & 48,590 \\
1952 & Termination & & & \\
\hline
\end{tabular}

\textsuperscript{101}\ Reg. \textsection 1.401-3(e)(i) (1963).
uted to the pension plan with respect to an employee in a particular year. It is likewise simple, in the case of the profit-sharing plan, to indicate the share deposited to the plan with respect to an employee in that year. However, certain actuarial funding methods do not lend themselves to individual cost computations and the Commissioner has generally accepted a statement in a footnote, at the bottom of the form, that individual cost methods should not be required due to the aggregate cost basis of determining contributions. It is, however, possible to apply the methods, factors, and assumptions on a level premium basis. By this method, one is able to determine the amount which would be contributed to the plan if funding were determined differently. The amount which may be said to be contributed with respect to such an employee is found by multiplying the contribution for the year by the ratio that one person's level cost so computed bears to the sum of such level costs. The Internal Revenue Bulletin on section 23(p)(1)(a) and (b) provided in part III(1) that

where the costs in a self-insured plan are determined by an aggregate method and cannot be satisfactorily allocated to an individual employee, entries under [certain items] indicating the method used and the accrual rates for the respective items may be acceptable if more detailed information is not specifically requested in the individual case. Specially computed costs with respect to individual employees may also be required in some case (as, for example, where a participant owns a significant proportion of stock).103

The Service has not been prone to make requests for individual cost allocations under such plans, but certain District Directors have shown a disposition to request individual cost allocations where the aggregate cost basis is used as a means of determining unreasonable compensation and discrimination. Some determination of the individual cost is required if a filing with the SEC must be made.104

Column 9: Determining Discrimination.—When the long form termination schedule is filed, the Service may very well attempt to determine (the Volckening105 case notwithstanding) that during the lifetime of the program such a disproportionate share of the contributions going into the pension plan have gone for the benefit of the shareholders that the program discriminated in its operation. Hence, it is questionable whether the Volckening case knocked out the 30 per cent rule. The court held that it would not apply the test as an absolute in determining whether discrimination existed or whether the plan was for the exclusive benefit of the employees. It did not state that it would never look to the proportionate allocation to determine discrimination. In fact, in

103. 1 CCH PENSION PLAN GUIDE § 14501, at § 14519.
the per curiam opinion of the Sixth Circuit in the Charles E. Smith & Sons Co.\textsuperscript{106} case, it was held, after the date of the Volckening case, that the trust in question had never been approved by the Commissioner. The court stated that

it plainly was not established for the exclusive benefit of the employees. Sec. 165, I.R.C. of the contributions made for the year ending July 31, 1942 — almost one half was allocated for the benefit of Hall C. Smith. For the year ending July 31, 1943 — almost one third was allocated for the benefit of Hall C. Smith. While Smith, as president of the corporation, was its employee, he was also sole stockholder and employer. As one of three trustees administering the trust, the two other trustees being employees, he was in sole control not only of the corporation, but of the trust, a substantial amount of which was laid out for his benefit. Since the trust did not qualify as exempt, the deductions were not allowable.\textsuperscript{107}

Inasmuch as the court had already held that compensation of Hall C. Smith, inclusive of the cost of his pension, was not reasonable, and therefore not allowable, the foregoing excerpt might be regarded as obiter dictum. However, the statement does present disturbing qualms as to the shield of the Volckening decision to a challenge of discrimination based on contribution allocation.

Did the Sixth Circuit tacitly overrule the Smith case when it rendered its decision in H.S.D. Co. v. Kavanagh?\textsuperscript{108} The opinion of Judge McAllister, one of the jurists who participated in rendering the per curiam opinion in Smith, notes with approval, the Volckening and Betty C. Stockvis cases\textsuperscript{109} which stand for the proposition that a plan is not discriminatory where contributions for shareholders, supervisors, and executives are higher than for others because of their higher salaries, and where the benefits bear a uniform relationship to compensation. However, the Smith case was not discussed.

In the author's opinion, the comparison of costs per person is not a proper test of discrimination for the reason that the plan must be examined to determine whether it is designed to accomplish the social scheme approved by Congress, or primarily designed to benefit but a few. If the "bait" to be held out to those in control of the destiny of the corporation to adopt the plan is the lure of deferment of a part of their compensation for tax purposes to a later date when it will be taxed at lower rates, then the true test involved is not whether the cost per employee is reasonable, but whether the cost of the entire plan is reasonable; not whether the cost of one employee's benefit is disproportionate, but whether many benefit as well. This attitude from a Canadian case is

\textsuperscript{106} Charles E. Smith & Sons Co. v. Commissioner, 184 F.2d 1011 (6th Cir. 1950).
\textsuperscript{107} Id. at 1014.
\textsuperscript{108} 191 F.2d 831 (6th Cir. 1951).
\textsuperscript{109} 10 CCH Tax Ct. Mem. 74 (1951).
exemplified by section 11(1)(f) of the 1948 Canadian Income Tax Act which permits the employer to deduct $900 "in respect of services rendered by each employee, officer or director of the taxpayer in the year." A question arose as to whether this meant $900 per employee or $900 multiplied by the number of employees covered. In No. 281 v. Minister of National Revenue, the Income Tax Appeal Board held that it was $900 multiplied by the number of employees, stating that the alternate interpretation of disallowing the excess per person over $900 would "nullify the clear intention of the Legislation which is to provide for adequate superannuation of employees upon their retirement." It is submitted, therefore, that an interpretation in the U.S. statute is likewise inappropriate where the result is to discourage adoption of the program.

When the long form termination schedule is submitted in connection with a profit-sharing plan, lack of entries in column 9 for years prior to termination, or the entry of minimal amounts, may result in a question as to whether the plan has been operated in compliance with the part of the Regulations which provides that "a (profit-sharing) plan does not qualify under section 401(a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers..." Just what test the Internal Revenue Service would use to determine whether there had been compliance with this rule is not clear, for mere absence of a contribution will not be sufficient to establish discrimination. In the Lincoln Electric case, the court held that the single contribution was substantial enough to accomplish objectives conceived at the time the statute was enacted, and it is likely that before holding that the absence of a contribution in any year produced discrimination, it would look for the motive and reason for failure to contribute. A short cash position, wage increases, labor problems, or a myriad of other economic factors can be present to rebut the imputation of discrimination created by the absence of a contribution.

However, it is not so easy to answer the situation that arises when the plan is non-discriminatory at its establishment, but then develops a census of employees which comprise a discriminatory group. In the Ryan School case the census was broad at the inception of the program and then narrowed to only a few persons. If, in lieu of discontinuing contributions, the employer had continued to contribute, and the plan had then terminated, would the Commissioner have claimed that the timing had resulted in discrimination? Perhaps it should be expected that the attitude toward discontinuance should be more liberal than indicated in the rulings.

The Ryan School case also suggests the questions which may arise when the reviewing agent examines the entry under column 9 of the

long form termination schedule in order to evaluate the effect of a reallocation of forfeitures. Revenue Ruling 61-157, part 5(d) stipulates that the forfeitures under a profit-sharing plan need not be applied in reduction of contribution, but that whatever method is used must not result in discrimination. A five year history of the allocation of forfeitures may show that a substantial portion of these were allocated to persons in whose favor discrimination may not exist in order to qualify. The totaling of the information required by Item 3(3), of Exhibit A would emphasize this factor. The safest method of allocation, therefore, is to apportion the forfeitures annually in the same manner as a contribution, not merely because of the problems on termination, but because the Service can always challenge the operation of the program.

Column 10: Employee Contributions.—It is not clear why the taxpayer should submit data as to employee contributions made in the five years before the plan's termination. However, the purpose becomes clearer when compared with the information required to be submitted under Item 4, of Exhibit A of Revenue Procedure 56-12. The comparison may reveal that some who were eligible did not contribute because of the amount required.

Summarizing this portion of the discussion, it may be stated that the submission of the long form schedule upon termination of the plan covering the most recent five year period is in many ways more revealing than the submission of the twenty-five highest schedule on establishment of the plan. Both are designed to reveal the nature of the group covered, discrimination as to contributions or benefits, unreasonable compensation, etc., but a better view of these factors in operation is obtained on examination of a sheet covering a five year, rather than a one year period. On submitting the information, counsel should attempt to assay the possibilities of a Service challenge, and review the case law which has been more favorable to the taxpayer than the Commissioner's rules.

Item 3(g), Exhibit A — Revenue Procedure 56-12

As indicated at the beginning of the discussion of the long form termination schedule, the final column of the schedule is to indicate the share of the assets of the program which will be distributed to those covered by the plan at the time of its termination. Revenue Ruling 61-157 part 5(c)(2) is the most recent in a series of rulings published by the Service which indicates that plans are to contain clauses covering disposition of assets upon termination. Just how to do this in advance is an adventure in clairvoyance, for the draftsman must attempt to deal with a problem usually far in advance of its occurrence in a manner which at that time will be considered fair, non-discriminatory, correct, and satisfactory. At the inception of the program, it is difficult to persuade the client to consider
the problem since it is the least of his interests, and further because the promoters of the program are usually the least anxious to suggest the problems of termination. There are few expectations for the person who sincerely wants to explore, at the time of birth, the problems of death. Indeed, no matter how sincere one may have been in dealing with the subject at the inception of the program, it is the writer's experience that circumstances of termination often compel complete revamping of the clauses for clarification. However, there are a few "ground rules."

The first step in revamping is to classify the plan. If it is a profit-sharing plan, the provisions for termination will be easy to draw at the plan's inception, for records of the individual equities will have been maintained during the plan's life. When the plan terminates, an inventory is taken of the trust fund and the value of the account of each individual is determined. The plan will normally provide that the forfeitures which have arisen since the last valuation of the inventory of the securities will be distributed among the accounts of the participants on an equitable and non-discriminatory basis. Usually, this is done by multiplying the forfeitures by the ratio of the amount in one person's account to the total amount in the accounts, although per capita allocations are also acceptable. If no contribution was made to the plan when last regularly due, pursuant to Revenue Ruling 55-186, the forfeiture will usually be construed by the Service as belonging to the participant who terminated employment and such individual will normally have to be included in the plan to receive the value of that forfeiture at the termination of the program.

If the plan is a pension plan, however, much more complicated problems arise. Dorrance Bronson points out in his celebrated article that subclassification of a plan is a fundamental consideration in determining the clauses to be included in the plan covering termination. For example, if the plan is of the individual policy pension trust type, the identification of equities is easily traced to the policy or policies acquired on behalf of each participant and any surplus funds arising by reason of final dividends, prior excess contributions, terminal year forfeitures, etc., are usually disposed of proportionately. Correspondingly, annuities under a group annuity contract are also easily identified and easily distributed. However, it is not so simple to dispose of assets of a fully self-administered plan, a deposit administration contract plan, a program involving individual ordinary life policies convertible to annuities at retirement with funds accumulating in a trust fund or insurance company deposit administration account, or a self-administered plan which at retirement has in some cases bought annuities. It is in these areas that counsel must recognize that money contributed has not been branded with the name of any person as being deposited for his benefit and that

111. 7 TRANSACTIONS SOCIETY OF ACTUARIES 225-57 (1955).
the time-worn statement that “money has no earmark” is particularly applicable. It is here that counsel must attempt to glean from his client how he wants the money divided, for he must understand that it is not necessary that all benefit upon termination, but rather that the distribution be non-discriminatory. Revenue Ruling 61-167, part 5 (c) (2) provides as follows:

For example, a distribution which benefits only the employees over the age of 50 at the time of termination of the plan or only those who have at least 10 years of service or only those who meet both age and service requirements may be acceptable if there is no possibility of discrimination in favor of employees who are highly compensated, etc. Such a situation may exist in a plan covering only wage and hourly rated employees. Upon termination, again provided that there is no possibility of prohibitive discrimination, the funds may be used first to continue benefits to retired employees, then for employees who have met the requirements for retirement but have not actually retired, then for employees over age 50 and so on until the funds are exhausted.

Various formulas are customary in these plans. One is that each person shall receive a disbursement proportionate to his actuarial value. Another is to develop classes with priority interest in the assets, usually giving the retired lives the highest priority. The classes are customarily fixed by age, the employees being divided into quinquennial age groups, starting with the age of the oldest non-retired employee. In other instances, classification by service completed is important. It is in drawing these clauses that mistakes most frequently appear that cause endless frustration at the time the plan terminates. The list below is not exhaustive, but may prove helpful in determining what to consider.

**Failure to Provide for Final Termination Expenses.**—When a plan terminates for business necessity, there may be no corporate funds to pay final counsel, actuarial, and trustee fees. If there are funds available, and the employer wishes to pay fees directly, the clause may be eliminated at the time of termination — a task easier to perform than amending at the time of termination to provide for reduction of plan assets by the amount needed to meet terminal expenses. Under the latter circumstances, an objection may be raised by those about to receive disbursements of the diminution of their equitable interests and consents may have to be obtained.

**Failure to Include in the Census All Persons Having Contingent Interests in the Program.**—Failure to have a broad enough census may arise for a variety of reasons, generally described as oversight. One cause of such failure is due to the difference between the terms of the union contract and the plan filed for qualification purposes.

The typical United Steelworkers type of contract, for example, provides that an employee who retires within the term of the contract would be the one who benefits exclusively. Provisions of this kind do
not lend themselves easily to prefunding of the benefit within the scope of PS 67. Therefore, a plan which could qualify for Treasury purposes was adopted to implement the union contract, the plan providing that there would be a funding of benefits on a different basis from that limited by the contract with the union. In the provision of the "Treasury" plan dealing with termination, the typical clauses provided that the funds within the trust would be applied first to provide benefits for those who had retired, and second for those who were eligible to retire with the balance reverting to the employer. It is significant to note, however, that within the scope of its power to rule upon the qualification of the program, the Service held that such a clause in a union program dealing with the distribution of money in a manner acceptable to the union upon the termination of a plan was improper. While consistent with the union contract, such a provision would violate the provisions of the law which stipulate that except for the case of an erroneous actuarial computation, none of the money may revert to the employer. The Service insisted that the balance of the money remaining within the plan upon termination must be applied to provide benefits for employees who were ineligible to retire as a contingent liability exists with respect to this group.

This common error also arises if mention of the equities to be distributed to persons having vested benefits is excluded from the termination provisions. Vesting may take many forms in a plan, but the most common in a self-insured plan or a program of the group annuity type is to provide that at the normal retirement date, the individual is entitled to receive the benefit which has accrued to him to the date of his termination of employment. In the self-administered plans negotiated by the auto workers, such vesting benefits were added by amendment rather than by original provision, and through oversight in many cases, no mention was made of the rights at termination of persons potentially eligible for vested deferred retirement benefits. The Service, within the scope of its power to provide that no reversion occur except upon satisfaction of all fixed and contingent liabilities, held that such termination clauses were improper. Usually, the problem has been cured in such programs by stipulating an enumeration of classes of employees by quinquennial age groups and then adding at the end a statement such as the following: within each of the foregoing groups shall be included former employees of the same age who, at the time of termination of the plan, are potentially eligible for a vested deferred retirement benefit, provided that they reply in writing within 90 days to a certified letter mailed to them no later than the date of termination of the plan indicating to the Board their whereabouts; but any such employee shall be entitled to share in the trust fund only after the satisfaction of benefits for active employees within the same class at the time of termination of the plan.
Response to a certified letter mailed to an employee is vitally important, for frequently it is difficult to know the whereabouts of the former employees. Failure to determine the census of the persons eligible for the vested deferred retirement benefits frequently results in an inability to prorate the fund inasmuch as such trust funds are normally not sufficient to care for all retirants.

Still another way in which errors are committed is to fail to recognize that there are persons other than the pensioners who receive benefits. Many plans stipulate that participants are eligible to elect optional methods of payment of pensions such that, upon the death of the retired participant, benefits will be payable to a survivor for a lifetime (joint and survivorship option) or for a period of time which when combined with the period in which payments were made to the pensioner in his lifetime does not exceed, for example, five or ten years (five or ten year certain options). Beneficiaries of participants under these conditions may in fact be receiving benefits, or if the participant himself has elected the optional method, may be themselves entitled to optional methods of payments at a later time. In such plans, it is necessary to provide that beneficiaries and contingent annuitants receiving benefits stand in the shoes of the retired participant. A corollary problem to that of assuring inclusion of beneficiaries and contingent annuitants is that of spelling out in the termination clause that:

(a) The benefit of one who has elected an option and is living at the time of termination will be valued according to the standard form of payment under the plan — life annuity, ten year certain, etc. — but will be adjusted, after determining the size of the share, to provide payment in the optional form selected;

(b) The benefit of the surviving contingent annuitant of a deceased pensioner will be valued (normally) as a straight life annuity, based on the age and sex of the surviving contingent annuitant; and

(c) The benefit of a beneficiary receiving payments to the end of a term certain is to be valued as the commuted value of the unpaid installments.

**Mistaken Inclusion.**—The error of including persons not potentially eligible for benefits occurs as a result of failure to correlate the termination provisions with the requirements for retirement benefits. It is a serious error because it depletes the assets of the program to the detriment of those who can potentially qualify for benefit and is difficult to remove at termination.

Many plans provide that employees age 65 or over and having ten years of service are eligible to retire on normal retirement pensions. The
termination provisions on the other hand will normally provide that the fund will be divided by first taking care of those who have retired and then taking care of those age 65 and over. Suppose an employee is age 65 at the time the plan terminates, has five years of service and cannot, because of a ceiling on the age up to which an individual may acquire service credit, accumulate sufficient credit for a normal pension should the plan continue. Under such conditions, it is recommended that the plan include an additional provision to the effect that no persons shall be included in any classification described above unless he could, assuming his fulltime employment, accumulate sufficient credited service to be eligible for a retirement benefit.

Failure to Recognize All Sources of Payments And Assets at Termination.—Nothing prevents the employer from providing in his plan that at retirement he may acquire annuities to provide the benefits for some employees and pay others directly from the trust fund. Such provisions often occur in certain so-called "combination plans" where insurance contracts are acquired that are convertible at the retirement age of the individual to provide the annuity but where it is contemplated that conversion will not occur in every case where (a) it is apparent that the health of the employee is so poor that payment of monies to the insurer might be impractical, or (b) where the cash position of the trust fund is such that it is not desirable to sell securities at the time of retirement, but rather to pay the pension payments from the trust fund while deferring the acquisition of the annuity from the insurer. Under such conditions, it becomes necessary that the annuity contract remain within the trust so as to provide for the payment of the pension to the participant and yet be subject to cancellation and reduction should the trust fund be inadequate to provide full retirement benefits at any particular time for those who have retired, but with respect to whom similar annuities have not been bought. Another part of the same problem is the need to recognize that at termination, final dividend payments are due the trust from an insurer.

When any pension plan, other than a fully insured pension plan, is terminated, there is the distinct possibility that the assets at the time of termination will fall short of the amount needed to sustain the benefits of the retired lives, or even if enough to sustain those benefits, will not be sufficient to provide any disbursements to anyone else. In the former situation, common law questions arise that will not be considered here. Aside from these, however, the Treasury Department may raise the question as to whether the program met the minimum funding requirements of Treasury PS 57, or, in a union negotiated case, whether the certificate rendered pursuant to Treasury PS 64 was properly earned. "Actuarial soundness" and "full reserve concept" of funding are not
synonymous terms and it may very well be that even if the employer desires to fund the full reserve, the limitations imposed by section 404 (a)(1) of the Code will not permit large enough deposits to be made on a deductible basis annually to accomplish this objective. In fact, funding at the minimum basis permitted by Treasury PS 57 will not usually result in accumulation of enough funds to provide adequate reserves. The actuarial assumption of a normal amount of labor turnover and withdrawal usually does not assume retirement by each person eligible for normal retirement when first eligible, much less early retirement at the earliest date for each person eligible. Yet, when the plan terminates, the retirement rolls are likely to swell suddenly as eligible employees climb aboard the bandwagon. This is particularly true if the plan terminates as the result of the closing of a plant, or shutting down of operations. Assurances of guarantee from an insurer who has issued annuities under a deposit administration contract are, at this point, likely to prove to have a meaning not accepted as being within the colloquial definition of guarantee, for as more people demand annuities, the insurer will reduce the annuities of those drawing benefits to add funds to be distributed among all who have retired. (The guarantee will be found, under these conditions, to be a guarantee of preservation of principal and annuity rates.)

The complaints of those failing to receive any disbursements whatever are likely to be more numerous in the case of the union negotiated, cents-per-hour type plan, for here the employees often think of the deposits made to the plan with respect to hours which they have worked as having been made on their behalf. The failure to receive any share of the fund under these conditions is an understandable disappointment which can promote time consuming inquiries, the likelihood of which the employer may wish to balance against the satisfaction of a limitation of his liability under the plan.

To effect a disbursement of the trust funds, it is normally necessary that the entire trust fund be reduced to cash so as to provide funds to purchase annuities, etc. In certain cases, it becomes desirable to deliver the equities in the fund to the participants in specie upon its termination. For example, an individual may no longer be insurable and subject to applicable requirements of state law. In such a case it may be advisable to deliver to him the insurance contracts issued on his life which were taken out at an earlier time. In other instances, stock of the employer may be the desired method of distribution. In others, it may be desirable to deliver annuity contracts to the individuals; and in still others it is desirable to disburse in a lump sum. The Service has normally accepted clauses included in the plans which provide that the method of disbursement may be any one or any combination of methods so long as the
value of whatever is distributed does not exceed the actuarial value of
the benefit of the participant in the fund at the time of its termination.

Terminal Tax Problems

The taxable nature of the distribution will unquestionably have an
influence upon the method of distribution. Sections 402(a)(2) and
403(a)(2) of the Code provide that where the total distribution applic-
able to a participant is made to him within one taxable year on account
of termination of employment, the tax on the distribution will be com-
puted as though distribution were a long term capital gain. The statute
precludes similar treatment where the distribution is made upon termi-
nation of the plan, except that section 402(e) provides that a distribu-
tion made in the calendar year 1954 as a result of termination of the plan
incident to the complete liquidation of the corporation occurring before
the date of enactment of section 402(e) would be treated as a separation
from service. In Edward Joseph Glinske Jr., the Tax Court had held
that the distribution to a participant was not a capital gain where the
participant continued in the employ of a new owner who, three weeks
after acquisition, terminated the plan. The maintenance of the plan
by the purchaser for this short period was damaging. In the
Mary Miller case, the plan and employment terminated simultaneously
in a situation where one department store bought the assets of an-
other, and the seller was dissolved. Clerks continued to work at the
same station for the new organization, performing the same work
for the purchaser as they had for the seller. The Service claimed that
in substance there had been no termination of employment, but the Tax
Court and the Sixth Circuit held otherwise. While the Commissioner
could have refused acquiescence in the theory of Mary Miller and held
on the basis of the clear stipulation of time in section 402(e) that Con-
gress did not intend that long term capital gain treatment be accorded
under facts similar to those in Mary Miller except where section 402(e)
would apply, he did not do so. Instead, in 1958, a series of rulings was
published which indicate that under circumstances where Mary Miller
could logically be thought to apply, i.e., simultaneous terminations of
employment and a plan, the long term capital gain treatment would
be applicable.

In Regulation 1.402(a)-(1)(a)(2), the rule is stated that the dis-

112. 17 T.C. 562 (1951). Would the result have been different if the distribution had been
defered until termination of employment after the termination of the plan? The cases do
not answer the question.
113. 22 T.C. 293 (1954), nonacq., 1955-1 CUM. BULL. 8, aff'd, 226 F.2d 618 (6th Cir.
1955).
tribution of an annuity contract will not result in tax at the time of distribution. Of all rules pertaining to termination of a plan, this is the most important in terms of sheltering lower paid persons from an undesirable tax consequence. The Regulation further provides, however, that a distribution of an insurance contract will result in immediate tax unless, within 60 days after distribution, the contract is irrevocably converted to an annuity. This must be kept in mind by those desiring to continue insurance.

Suppose a participant wishes a distribution partly in cash and partly in the form of a contract. In a private ruling letter known as the Beanisto letter, it was held that the lump sum would be taxed as a capital gain and the tax on the annuity deferred. Coupling this ruling with the Mary Miller rulings suggests interesting pre-termination planning.

Special rules apply when stock of an employer is distributed. In a discussion of this subject, the following has been stated:

The benefit referred to is a deferment of tax on any unrealized appreciation in the value of the securities. Under a contributory plan, the appreciation is not taxed at the time of distribution to the extent attributable to contributions by the participant, regardless of whether the distribution occurs during employment, upon termination of employment or after termination of employment, and whether at one time or in installments.

In the case of a non-contributory plan, the unrealized appreciation is excluded from currently taxed income only if the distribution represents the balance or part of the balance of the total distributions payable, and is made within one taxable year of the distributee — that is, a distribution which would qualify for long-term capital gains treatment under the usual rule.

The tax rule relative to unrealized appreciation of employer securities does not mean, of course, that the participant escapes tax on the distribution. At most, it is the tax on unrealized appreciation which is deferred. To the extent that the securities were purchased by the trust from sources other than employee contributions, the participant is subject to tax, possible at capital gains rate, computed upon the cost of the securities. This cost becomes his cost basis for determining gain or loss if and when the participant makes a sale or other taxable disposition of the securities. However, if the participant holds the

115. P-H Pension and Profit-Sharing Service § 5305.
116. Code §§ 402(a) (3) (A), (B).
117. Code § 402(a) (1).
118. Code § 402(a) (2).
119. Reg. § 1.402(a)-1(b) (1) (ii) (1963). As to the rules for determining the cost of securities, either on an earmarked or an average basis, see Reg. § 1.402 (a)-1(b) (ii), Rev. Rul. 354, 1955-1 Cum. Bull. 396; Rev. Rul. 514, 1957-2 Cum. Bull. 261. A fine point of distinction is made in Reg. § 1.402(b) (1) (ii) that where there is a lump sum (one year) distribution, any realization of unrealized appreciation is considered long-term gain regardless of the holding period of the employee. However, any excess of gain over the net unrealized appreciation at the time of distribution will be long-term or short-term, depending on the employee's holding period.
securities and does not sell them, he escapes income tax entirely on the unrealized appreciation.\(^{120}\)

Again, the necessity of evaluating whether the distribution will be taxed as a long term capital gain must be made. The tax consideration may have to give way to a consideration of retaining corporate control.

The distributee is not alone in tax problems upon termination of a plan. The employer who has contributed in excess of allowable limits may also have his problems. For example, suppose that the taxpayer elects to make a final terminal contribution in excess of the limit allowable for deduction in a taxable year. Will he be able to carry the amount forward and deduct the excess in years when the trust no longer exists? Section 404(a) (1) (D) provides for a carry forward of the undeductible excess under a pension plan, and the third sentence of section 404(a) (3) (A) provides for a carry forward under a profit-sharing plan.

Regulation 1.404(a)-(9) (a) provided that for an excess contribution to be deductible in a taxable year later than the one in which made, the trust must be exempt in the taxable year in which the deduction is claimed. Obviously, a non-existent trust cannot be exempt. In \(\text{Royer's Inc. v. United States}\),\(^{121}\) the court noted that the Regulations were predicated on statutory language found in the United States Code Annotated. Counsel for the taxpayer, however, pointed out that the text upon which the Commissioner relied did not appear in the statute as printed in the Statutes at Large. The court held that the statutes of the United States are as set forth in the Statutes at Large and accordingly held the Regulation invalid. In T.I.R. No. 181, the Commissioner stated that he would follow the case.

Regulations 1.404(a)-3(a) and 1.404(a)-8(a) (2) also implied that in order for the excess contribution to be deductible, the trust must be in existence and qualify in the year when the deduction is claimed. T.I.R. No. 181 has also amended that implication and accordingly the carry forward pursuant to Regulation 1.404(a)-7 would apply. Mergers and consolidations have presented unlimited problems in the field of qualified plans,\(^{122}\) but it was early held in PS 62 that in a statutory merger a corporate successor could carry forward and deduct the prior undeducted excess of a predecessor company. The rule has achieved statutory confirmation in section 381(c) (20) of the Code.\(^{123}\)
Summary of Form Procedure Under Revenue Procedure 56-12

Item 3, Exhibit A.—There is no more burdensome chore upon termination of a plan than preparation of the long form termination schedule. The data disclosed should cause counsel to review it to determine challenges of unreasonable compensation and discrimination. In anticipation of termination and the filing of data showing distributive shares upon termination, care must be taken at the inception of a plan to draft a workable termination clause, having in mind possible tax consequences. When termination does occur, the structure for termination must be reexamined; where necessary, amendments should be made to correct an oversight, eliminate discrimination, produce greater equity, conform to factors not foreseeable when the plan was first drawn, and to work to the greatest tax advantage of the distributees and the employer. Not all of these problems will be suggested by the long form termination schedule, but it will reflect whatever solution will be given to the problem.

Item 4, Exhibit A.—This item requires that there be furnished a schedule showing separately for the year in which the plan is terminated or curtailed and for each of the preceding years of the plan’s operation (not in excess of 5, unless requested):

(a) The number of participants at the beginning of the period.
(b) The number added.
(c) The number who dropped out.
(d) The number remaining at the end of the period.

This information is very similar to the data required by Regulation 1.404(a)-2(a)(5). Pursuant to Regulation 1.404(a)-2(b), the same information must be submitted annually for each year the program is claimed to qualify under section 401(a). Hence, the preparation of the data is not difficult.

The final paragraph of Regulation 1.404(a)-2(a)(5) provides that in each year in which the plan is claimed to qualify under section 401(a)(3)(A), data and computations necessary to establish qualification must be submitted.124 Section 401(a)(3)(A) is a provision of the statute seldom used to establish qualification. Often cited as the “arbitrary rule,” it provides that if certain percentages of employees are covered, the plan qualifies without having to prove no discrimination. Presumably, a program which has established its qualified status on that basis each year would be filing the data in vain and a waiver might properly be requested under Regulation 1.404(a)-2(e).

Since proof of qualification under the “arbitrary rule” is not likely to be enhanced or hampered by proof of the consolidated census schedule, it follows that the information submitted is to be examined for another rea-

124. Reg. § 1.401-3(a) (1963) indicates the manner of proof.
son. It is suggested that the agent will correlate the data in Item 3 with the data in Item 4 in order to determine that inclusions and values applying to those included present a discriminatory pattern when compared with those excluded. However, to the author's knowledge this argument has not been raised.

Item 5, Exhibit A.—This item requires "a statement as to whether any of the funds under the plan will revert to or become available to the employer; if so, details are to be furnished."

Section 401 (a) (2) of the statute requires that the trust, to qualify, must provide that prior to the satisfaction of all liabilities, no part of its corpus or income will be used for purposes other than the exclusive benefit of employees or their beneficiaries. Hence, a reversion to the employer is possible. Regulation 1.401-2 discusses the meaning of this section, but perhaps it is not amiss to quote from article 165-1 (e) of the Regulations under the 1939 Code which differs somewhat from the current regulations, but which is of interest since it was adopted so close to the date of adoption of the provision.

Meaning of "liabilities".—The intent and purpose in section 165 (a) (2) of the phrase "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust" is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, such balance in the trust as is due to erroneous actuarial computations during the previous life of the trust. A balance due to an "erroneous actuarial computation" is the surplus arising because actual requirements differ from the expected requirements based upon previous actuarial valuations of liabilities or determination of costs of providing pension benefits under the plan in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding, all as made by a careful person skilled in calculating the amounts necessary to satisfy pecuniary obligations of such a nature. For example, a trust has accumulated assets of $1,000,000 at the time of liquidation, determined by acceptable actuarial procedures using reasonable assumptions as to interest, mortality, etc., as being necessary to provide the benefits in accordance with the provisions of the plan. Upon such liquidation it is found that $950,000 will satisfy all of the liabilities under the plan. The surplus of $50,000 arises, therefore, because of the difference between the amounts actuarially determined and the amounts actually required to satisfy the liabilities. This $50,000, therefore, is the amount which may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial calculation. The term "liabilities" as used in section 165 (a) (2) includes both fixed and contingent obligations to employees. For example, if 1,000 employees are covered by a trust forming part of a pension plan, 300 of whom have satisfied all the requirements for a monthly pension, while the remaining 700 employees have not yet completed the required period of service, contingent obligations to such
700 employees have nevertheless arisen which constitute “liabilities” within the meaning of that term. It must be impossible for the employer (or other nonemployee) to recover any amounts other than such amounts as remain in the trust because of “erroneous actuarial computations” after the satisfaction of all fixed and contingent obligations, and the trust instrument must contain a definite affirmative provision to that effect, whether the obligations to employees have their source in the trust instrument itself, in the plan of which the trust forms a part, or in some collateral instrument or arrangement forming a part of such plan, and whether such obligations are, technically speaking, liabilities of the employer, of the trust, or of some other person forming a part of the plan or connected with it.\textsuperscript{125}

The term “erroneous actuarial computation” is a handy term, but a misnomer. In essence, it means that experience under the plan indicates that the plan has not performed according to its assumptions, and that accordingly there is a surplus of money. It can come about through market appreciation of a portfolio valued at cost, mortality in excess of that anticipated, or a host of any other reasons. Unanswered is the question of whether those discharged prior to closing down a plant constitute a group with respect to which there are contingent liabilities. It is not possible for any surplus to remain under a profit-sharing plan.\textsuperscript{126}

Usually, there are no returns under the individual policy pension trust. In Revenue Ruling 61-157, part 3(f) (3) and (4), the Service held that dividends on contracts earned after discontinuance of the plan could be applied to buy additional retirement annuities, or be returned directly to the employer on a theory analagous to that of a return of an erroneous actuarial computation.

\textit{Item 6, Exhibit A.}—Here there is required “a statement with full particulars as to any funds under the plan which at any time were contributed in the form of or invested in obligations or property of the employer or related companies.”

The investment by a trust in stock or property for an employer presents a special field in itself, and no attempt is made to cover it in this article. It has been studied from its social implications,\textsuperscript{127} and has been of interest to the tax lawyer for many reasons, not the least of which is that a deduction may be taken from corporate income with one hand, and the money returned to the corporate treasury with the other. It also has interesting estate planning implications, for a trust may enter into an agreement with a shareholder to purchase his shares at death, thereby fulfilling the requirements of a “buy and sell” arrangement where the provisions for redemption might otherwise be barred by state law.\textsuperscript{128} It

\begin{itemize}
\item \textsuperscript{127} See Harbrecht, Pension Funds and Economic Power (1959).
\item \textsuperscript{128} See, \textit{e.g.}, \textsc{Ohio Rev. Code} § 1701.35.
\end{itemize}
might also provide a vehicle for taking a deduction by contributing authorized but unissued shares where there is no cash available for making a contribution. In a management fight, it would be possible for management to contribute shares to the trust in order to vote them. Such variations of employment and exploitation are almost unlimited. Nothing in the statute prohibits an employer from causing a trust qualifying under section 401(a) from investing in his shares. In fact, section 402(a)(2) seems to presume that it has been done in discussing the taxable nature of the distribution of such funds. Regulation 1.401-1(b)(5) states that there must be a full disclosure of the reasons for the investment. In Treasury PS 49, the Service first stipulated the information which must be filed to effect a disclosure, and currently, substantially the same information is required to be filed on Form 990-P which is the annual information return which the trustee is required to file under section 6033 of the Internal Revenue Code. If the employer wishes to obtain a predetermination of the propriety of having the trust make the investment, the request would be made for a ruling under Revenue Procedure 56-12, and disclosure made in accordance with the requirements of Exhibit A.

It is not only stock of the employer in which the trust may invest, but other property as well. In Revenue Ruling 46, the Service noted that nothing prevented the trust from investing in property of the employer who created the trust, but that where deductions would be attempted in connection with transactions involving such property, the size of the deduction would be limited to the amount applicable under section 23(p) (now section 404) if it were found that the transaction was not bona fide. It would appear that the Service had in mind certain lease transactions which would involve collection of rent by the trust. But the danger of running afoul of the prohibited transaction rules of section 503(c) must be kept in mind.

Despite the stringent nature of the restrictions imposed upon investing in stock or property of the employer, the advantages are so great that employers have not been deterred from making such an investment. Hence, the possibility exists that at termination, it will be revealed that some facet of the transaction has resulted in discrimination, or that the program has not operated for the exclusive benefit of the employees. Few cases have arisen in which the Service has challenged the qualification of the trust.

129. There are two ways that an employer may cause the portfolio to hold his securities. The most common is to direct the trustee to so invest the fund. The second is to make the contribution in securities, in which event the fair market value exceeds the cost basis of the securities contributed. See, e.g., International Freight Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943). Presumably, the rule would apply whether the stock was that of the corporation or that of another company. In United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960), the employer contributed depreciated property. The court held that the gain must be figured on the excess of fair market value over depreciated basis.
because of the nature in which the investments were made. Perhaps the most notable is that of H.S.D. Co. v. Kavanagh.\footnote{88 F. Supp. 64 (E.D. Mich. 1949), rev'd, 191 F.2d 831 (6th Cir. 1951).} There, the district court noted that the taxpayer had set up two plans, one called the "Executive Trust," and the other the "Employees' Trust." The court held that where the employer sets up two plans, both must be jointly considered to determine discrimination.\footnote{See also P.S. No. 27.} The original res of each trust was invested in common stock of the employer. However, twice as much had initially been contributed to the Executive Trust as to the Employees' Trust and no later contributions had been made to the Employees' Trust. Subsequent contributions made to the Executive Trust were applied to exercise an option to purchase the Employer's plant. A profit of $14,000 was later realized from that transaction. Three years after the trusts had started, the Executive Trust, covering four employees, had a gain of $51,838.88. The Employees' Trust, covering twenty-three employees, had gained less than $750. The assets of the former were $55,400 and of the latter, $12,800. Based on this background, the Commissioner revoked his favorable determination letter. He was sustained in the district court, but the Sixth Circuit reversed.\footnote{H.S.D. Co. v. Kavanagh, 191 F.2d 831 (6th Cir. 1951).} The latter court held that it was proper for the trustee to invest in the employer's securities, and that mere investment in such securities would not of itself result in an inference that the program was being operated for only a few executives. Moreover, the court held that the government had failed to meet its burden of proving that the option had been acquired for less than market value, or that the company had diverted profits. In substance, the court held that discrimination cannot be established from results; the government must prove that the facts produced discrimination. The court relied heavily on the government's original approval of the program. The case is significant because of its lengthy and intelligent discourse on the subject of investments.

**Terminating Multi-Employer and Union Negotiated Area and Industry-Wide Plans**

**Multi-Employer Plans**

Aside from classifying plans as profit-sharing or pension, and then sub-classifying pension plans by formula (unit credit, fixed benefit, or money purchase) and by funding medium (insured or self-administered), a further evaluation of a plan must be made to determine whether it is a program to which more than one employer has contributed. Section 401(a) does not provide that a plan may be maintained jointly by more than one employer, although section 404(a)(3)(B) speaks of a profit-
sharing plan maintained by employers affiliated under section 1504. However, the Regulations provide that joint maintenance is possible if all the requirements are otherwise satisfied. It is not necessary that the relationship of parent and subsidiary exist. What is necessary is that the plan qualify with respect to each employer, and further that there be a division in cost, preferably on a proportionate compensation basis.

Benefits may be computed on the basis of consolidated earnings, the Service having gone so far as to hold that in an "integrated" plan, the benefit may be figured on the basis of earnings in excess of $4,800.00.

Special problems arise when terminating such a plan with respect to one employer, but not with respect to all. There appear, despite the plethora of Treasury Department rules on virtually every subject, to be no published rules with respect to this topic. As in the case of the single employer program, termination is easy where the equities of participants can be identified, as in the case of a profit-sharing plan or individual policy or group annuity pension plan, but the problems arise when the plan is a wholly or partially self-administered plan. In the latter case, benefits are likely to have been funded on the basis of a common consolidation of

133. Cf. Reg. § 1.401-1(d) (1964). There are precedent regulations under prior Internal Revenue Codes.
134. INT. REV. CODE OF 1939 defined corporations connected through stock ownership. In P.S. No. 14, the Service held that affiliation within the scope of that statutory provision was not required.
135. See P.S. No. 14. It has been ruled that the subsidiary of a parent corporation may not adopt the plan and have the plan "qualify" under CODE § 401 (a) if at the time of adoption it has no personnel who meet the eligibility requirements of the parent's otherwise qualified plan. Rev. Rul. 56-629, 1956-2 CUM. BULL. 1056.
136. See P.S. No. 51, pt. A.
137. This term has not heretofore been used. CODE § 401 (a) (5) provides that a plan will not be discriminatory merely because it excludes employees "the whole of whose remuneration constitutes 'wages' under CODE § 3121 (a) (1) (relating to the Federal Insurance Contributions Act)," i.e., have earnings not exceeding $4,800 per year. The Service has consistently held that Congress impliedly restricted the size of the benefit based on earnings in excess of $4,800 so that the value thereof would not exceed the value of benefits under social security if social security benefits would be based on excess earnings. See I.T. 3613, 1942 CUM. BULL. 475; I.T. 3614, 1943 CUM. BULL. 476; I.T. 3615, 1943 CUM. BULL. 477; Mim. 5539, 1943 CUM. BULL. 499; P.S. No. 30; Mim. 6641, 1951-1 CUM. BULL. 41; Reg. § 1.401-3 (c) (1) (1965). Cf., Cavell, A Note on Plans Involving Integration with Social Security Benefits, in 6 PROCEEDINGS OF THE CONFERENCE OF ACTUARIES IN PUBLIC PRACTICE 207-21.
138. Senator Robert Taft did not believe the Treasury Department's position to be consonant with the law. In Taft, Pension Trusts and Welfare Funds, Journal of Commerce, May 29, 1946, the author states:

The requirement that the pension funds be integrated with Social Security has always seemed to me unsound. The Government has chosen to take a special interest in persons earning $3,000 and less, but there seems to be no reason why a company may not treat on a more liberal basis those in whom the Government has taken only a minor interest . . . . The private plan should conform to certain definite specifications applied to it, but if it overlaps the Social Security law, what difference does that make? Furthermore, I am quite confident that Congress never intended the Commissioner to have power to compel integration.
actuarial factors. In other words, the program is likely to be valued as if
the employees are employed by one employer instead of several. The
problem then arises as to what portion of the trust fund can be segre-
gated from the portfolio and then distributed to the participants of the
retiring company. The problems are compounded when, in closely af-
affiliated companies, employment transfers occur on closing down of one
company.

How then is counsel to accomplish the objective of equitable segrega-
tion at termination by the tool of text adopted when the plan is inaugu-
rated? First, the plan does not have to provide that there will be any
change in its operation. It may provide that those who retired originally
may continue to draw benefits. With respect to deductions, Revenue
Ruling 56-629 provides that a parent may contribute and take deductions
for money paid to fund pension credits earned with respect to the parent
and not the subsidiary. Thus, a basis of deduction of limited applicability
is afforded for contributions by the parent if the subsidiary terminates.
If there is no pension cost applying to the parent, then the terminating
subsidiary may make a final contribution to the plan in which event the
problems of the carry-forward must be considered. The details of de-
determining the liability of the subsidiary in this respect may have to be
worked out in a contract carefully drawn in collaboration with the actuary.
Such agreements are complex where the stock-ownership in the subsidiary
is not the same as in the parent, and where the transaction takes on
certain arms length proportions.

Second, if the plan does provide that there must be a segregation, the
plan's textual mandate should be couched in broad, general terms such as:
an actuarial valuation shall be made to segregate the assets applicable to
the group with respect to which the plan is being terminated from the
other assets. The segregated assets may then be allocated on such a basis
as would exist in an individual employer situation. However, this is not
the only means. The provision can also be couched so as to weight the
segregation in terms of the length of time of contribution by the terminat-
ing employer.

Each situation involving the termination of an individual employer in
a multiple affiliated employer program has, in the experience of the
writer, presented situations so unique that the broader the language pres-
scribing termination procedures, the better. In this respect, it is necessary
to be flexible to revise the program if that should prove desirable.

The Service has not discussed the proper text to be used in developing
clauses to implement Mimeograph 5717 in multiple-employer, multiple
payroll cases.

139. See p. 723 supra of this text.
Union Negotiated Plans

In a previous part of this article, mention was made of the necessity of notification by the employer to the union, or vice versa, that a negotiated plan shall terminate. Aside from this problem of notification, it has been the writer's experience that it is necessary for the parties to negotiate an agreement of termination, stipulating:

(a) that the employer has paid in full the sums he owes by contract;
(b) that the union releases the employer from further liability;
(c) that the parties agree as to who shall be included in the census of persons to receive benefits, and their shares;
(d) that the parties agree on the means of distribution of the shares;
(e) that the parties agree on the amount of payment of expenses and fees; and
(f) other matters.

Such an agreement is highly advantageous to the employer in the single employer single union type negotiated program. It may not, however, be necessary to negotiate any such arrangement in the industry-wide plan or area-wide plan.

Industry-Wide and Area-Wide Plans

Early in the development of negotiated pension plans, labor attempted to incorporate provisions for reciprocal credits into negotiated plans. The result of such an arrangement would have been to transfer a liability to another plan and the certification of actuarial soundness, required in the "cents-per-hour" plan, could not have been made without some knowledge of the details of these agreements. As an alternative, "area-wide," "industry-wide," and "association-wide" plans came into being. Area-wide plans cover employees in the same union in a certain geographical area who are not necessarily in the same industry. Industry wide plans cover employees in the same union who are, but need not be, in the same geographical area.

In all of these programs, free transfer of pension credits is possible. There is no difficulty in giving the certification of actuarial soundness where the contribution rate and benefit amount are fixed. The employer is not reluctant to grant vesting or credits for work done with a competitor since he knows what the cost of these liabilities are (cents-per-hour-wise) and his commitment does not go beyond that amount. But more

141. Ibid.
important, there is one trust, and the portfolio is large enough to permit long range investments, thereby increasing the yields, and the group covered can pool mortality after retirement. As in the multi-employer plan, the program is valued on a consolidated basis.

It must be recognized, in considering termination problems of a single-employer under an area or industry-wide plan, that there is an affiliation among the employees rather than the employers. As such, there are reasons why benefits should not be affected if the plan continues after the withdrawal of one employer.

First, the plan may be treated as though it were a plan for a single employer having a multiple number of plants. Under such an approach, the closing down of a plant does not affect the operation of the plan. Those employees who have retired prior to the termination of the plant, or who retire at the time of the plant's closing will receive their pensions, and those with vested interests according to the terms of the plan will continue to have potential vested benefits from the program. Those who are not otherwise vested upon termination of employment are, as before, not vested. This seems to work out particularly well where the program is valued on the basis of all the employers contributing uniformly with respect to all the employees. This is analogous to a single employer who contributes uniformly without regard to any of its subdivisions closing down.

Second, the plan may be regarded as a plan being maintained by the employees, with contributions being made by the employers instead of the employees, only to avoid any tax which might be imposed upon the employees before they contribute to the trust. The actuary would value the program from the beginning on the assumption that all of the employees, no matter where they are working, were going to contribute to the plan during all of their working life, and would ignore the possibility that any of them would be thrown out of the contributing group by reason of undue labor turnover caused by closing down any of the enterprises which employ them. On this basis the contribution is fixed, and as fixed, either at the time of establishment or on renegotiation, the benefit changes according to the measurement of actuarial liabilities and assets. It is to be noted in this respect that there is no difference between the conclusion reached if this philosophy is followed or the first philosophy is followed.

The theories presented above are appealing in a program where there is a uniformity of contribution rate and where contributions are not made to the plan by any particular employer with regard to its own actuarial liabilities, and where there is such free transferability of employment that

142. *Cf. Rev. Rul. 190, 1954-1 Cum. Bull. 46*, which holds that employees required to contribute to a pension fund to maintain union status may deduct therefor if they itemize. However, where the employees claim a standard deduction, the ruling is not of much help.
those who are employed by the terminating employer may be reemployed by other contributing employers in the same area and industry.

It should be recognized that in these programs, contributions are negotiated and the parties then negotiate a change in benefit. The benefit is then influenced by the effect of the addition on the new employers, and by the withdrawal of companies. So long as the parties have accepted the benefit as being reasonable, and the issue of contributions is closed, there is little merit to effecting a partial termination.

When a union plan terminates, the Service normally waives the filing of customary information under Items 3 and 4 of Exhibit A, Revenue Procedure 56-12. In Revenue Ruling 55-204, the Service indicated that it would accept a simplified basis of filing information in area-wide and industry-wide plans. There is reason to believe, therefore, that the detailed information required by Revenue Procedure 56-12, Exhibit A, would not have to be filed.

**CONCLUSION**

The widespread tax implications which result from termination of pension and profit sharing plans suggest the importance of anticipating the tax consequences at the inception of such plans. It is not suggested, however, that excessive caution should lead to reluctance to inaugurate such plans. Rather, the intention of the author has been to emphasize that pension and profit sharing plans are significant factors in today's system of employer-employee relations — not to be blindly adopted or blithely dropped.

Many of the problems discussed in this article are less likely to occur if, after proper drafting of the original instrument, adequate records are maintained. Employers who carry out such obligations are in a better position to adjust to the realities of the business cycle which may ultimately dictate that a plan be curtailed or terminated.
APPENDIX

Twenty-five Highest Employees Schedule*

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<th>NAME OF EMPLOYEE</th>
<th>SCHEDULE (A)</th>
<th>SCHEDULE (B)</th>
<th>SCHEDULE (C)</th>
<th>SCHEDULE (D)</th>
<th>SCHEDULE (E)</th>
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