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Treasury Mimeograph 5717—Government Rules Restricting Disbursements on Termination of a Pension Plan*

Sheldon M. Young

INTRODUCTION

Following the enactment of the provisions in the Revenue Act of 1942 requiring that a program of limited coverage be nondiscriminatory in order to be one to which tax deductible contributions could be made, the Internal Revenue Service proceeded to publish rules which the taxpayer would be required to follow to receive a ruling letter stating that the program met applicable requirements of the statute. It was to be expected that the psychology which had been developed in the decade before 1942, when the Treasury Department resisted claims for deductions to plans with limited coverage, would influence the formulation of the acceptable criteria. Inasmuch as complaints had sometimes been heard from the socially conscious New Deal Administration about the large percentage of contributions being applied toward the benefit of a few stockholder-employees, it is not surprising to find that the Treasury Department early stipulated that it would determine discrimination, yardstick-wise, by measuring the per-

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* The foregoing article was written as a chapter of a Master Thesis presented at the Western Reserve University School of Law in 1962. In the autumn of 1962, the Internal Revenue Code was amended so as to include a new provision therein (§ 401(a)(7)). Essentially, this provides that upon termination of a plan, all interests are nonforfeitable to the extent then funded. However, that statute goes on to state that the provision requiring nonforfeitability 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 Regulation 1.401-4(c)(2)-(5) inclusive. These reiterate substantially the rules originally promulgated in 1945 as Mimeograph 5717 restrictions.

A subsequent article will consider the effect of the publication of these restrictions on the higher pedestal of Regulations under the implied statutory authority of 1962.

1. For conflicting decisions, compare W. F. Parker, 38 B.T.A. 989 (1938), with Albert W. Harris, 8 P-H Tax Ct. Mem. 807 (1939).

2. WINSLOW & CLARK, PROFIT SHARING AND PENSION PLANS 95 (1939), quotes a letter from Secretary of the Treasury Morgenthau to President Roosevelt complaining of the abuse of the pension deduction.
centage of contribution being allocated to the stockholder-employee group. In I.T. 3674, 1944 Cum. Bull. 315, the Department stated that a pension or profit-sharing plan generally would not be considered in favor of shareholders owning more than ten per cent of the establishing employer's common stock if contributions required for their benefits would not, in the aggregate, exceed thirty per cent of the contributions for all participants under the plan. This is a negative way of saying that where the contributions under the plan allocated to the ten per cent stockholder group would exceed thirty per cent of the contributions for all participants, the plan will be considered in favor of the stockholder group and, therefore, would be considered discriminatory. The ruling was so applied almost universally.\(^3\)

Two days after it published I.T. 3674, the Service published a complementary rule, Mimeograph 5717.\(^4\) Just as I.T. 3674 sought to measure, in terms of monetary allocations, discrimination at the establishment and during the operation of a plan, Mimeograph 5717 sought to measure, in terms of monetary allocations, discrimination at the plan's termination; it was to answer the following question: for the party establishing a plan to receive a favorable ruling letter, what rule must be set forth in the plan's text to avoid improper application of money upon its termination? The rule laid down in Mimeograph 5717 and its subsequent explanatory rulings\(^5\) has necessitated the inclusion of clauses in plans and trusts restricting, according to a formula, disbursements from a trust to a limited group in the event of the trust's termination within a limited time after establishment. Paraphrasing Mr. Churchill, seldom in the one thousand year history of Anglo-Saxon trust law has one clause been included in so many documents in so short a time with such little understanding.

**OBJECTIVES OF THE TREASURY DEPARTMENT**

Before examining the rule required by the Mimeograph, it is advisable to gain an insight into the objective of the Treasury Department in publishing Mimeograph 5717. A good statement of the problem the Department was attempting to solve may be found by referring to the opening sentence of part 5(d) of Revenue Ruling 57-163: "If benefits for employees who are officers, etc., are funded, or substantially so, because of their nearness to retirement, and benefits for other employees are not similarly funded prior to termination of the plan, the

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5. P.S. Nos. 8, 25, 29, 31, 38, 42, 50 and 52 [P.S. Rulings may be found in 2 P-H Pension & Profit Sharing Serv. 5 12,302 and are hereinafter cited as P.S. No.].
prohibited discrimination will result.” At the time Mimeograph 5717 was published, the most prevalent type of approved pension plan was that funded by the purchase of individual policies with reserves at maturity sufficient to provide the amount of annuity to which a participant is entitled at the policy maturity date, i.e., his “Normal Retirement Date.”

To attain this reserve, the premium for a policy of this type is so constructed as to require that the last premium is paid on the anniversary date of the policy, one year before its maturity date. This type of funding, known customarily as the individual level premium method of funding,\(^6\) obviously requires that a very substantial sum of money be contributed to a plan over a short period of time where the period elapsing between the time that an employee becomes a participant in the plan and his normal retirement date is minimal. Under such circumstances, it can be anticipated from the inception of the program that a substantial sum of money each year for a small number of years will be allocated to the benefit of the participating stockholder-officer-highly-paid-supervisory group. If we assume that the parties establishing the plan are motivated solely by a desire to benefit merely this group, with respect to which discrimination may not occur under the provisions of the statute, and presuppose that they will terminate the plan when the interests of this group are fully funded, it is easy to understand the fear of early termination and the desirability of adopting a rule to prevent a plan from becoming part of a machination to divert money from the tax collector’s coffers to the pockets of this elite group.

It is to be noted, however, that neither the funding medium nor its funding method\(^8\) — that is, whether it is (a) funded on an insured basis by purchase of policies and costed in individual level premium amounts from entry date to normal retirement date, or (b) funded as a trusteed, self-administered plan where costs are not usually so individually computed — governs the application of the rule set forth in Mimeograph 5717. In the usual non-contributory, self-administered type of plan, trust funds most often are allocated upon termination of the plan by giving those who have retired and who are eligible to retire the first right to the assets (usually without priority within the retired group to the assets according to time of retirement) and then proceed-

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6. "The 'individual policy pension trust plan' is the basis of more insured pension plans than all other types combined." Perkins, *Characteristics of Insured Pension Plans*, in *PENSIONS: PROBLEMS AND TRENDS* 167 (Irwin ed. 1955) (published for the S. S. Huebner Foundation for Insurance Education, University of Pennsylvania). "It would appear that about two-thirds of all pension plans in the country are insured." *Id.* at 163.


ing by quinquennial age groups to allocate the balance of the assets in the plan to provide benefits for the other employees. In case of insufficiency of assets to provide for all groups, the older groups have priority. The net effect, therefore, is that while the money entering such a plan is not specifically set aside at the time of entry for costs identifiable as to a particular employee, the amounts usually are made identifiable with respect to an employee upon the plan's termination. Furthermore, even though the funding method employed in the self-administered plan does not normally contemplate having the full reserve for pension deposited in the plan at the time of the retirement of the individual (as does the level premium basis), the application of the money upon termination of the plan according to the priority as outlined above will result in the full funding of the retirement benefit for the oldest employees first. Where the senior employees of a company are its stockholder-executive-supervisory class, acceleration of funding their reserves on early termination of the plan runs afoul of the Treasury Department's theory.

The Commissioner states in Mimeograph 5717 that he will not regard a plan as being discriminatory where it contains a clause to the effect that in the event of the plan's termination, the maximum contributions of the company which may be applied toward any one of the twenty-five highest paid employees at the inception of the plan whose then anticipated annual rate of benefit is $1,500 per year, is the larger of (A) $20,000, or (B) twenty per cent of the first $50,000 of five year average regular annual compensation (but not over $10,000) multiplied by the years of existence of the program.

JUDICIAL AND ADMINISTRATIVE INTERPRETATION

Certain court cases and certain Treasury Department acquiescences to those decisions lead one to the conclusion that the text required to be included in a plan by Mimeograph 5717 does not provide tests which are proper for determining whether the discrimination prohibited by the statute exists.

The first of the court cases involved I.T. 3674, referred to above, and the rule customarily called the "30% rule." In that case, Volckening, Inc. v. Commissioner, the "30% rule" was a rule of general application to be considered with all other facts and could not be applied by itself as an exclusive test of discrimination. The facts before the court disclosed that of the eight employees who were participants in the plan, two were stockholders to whom 58.3 per cent of the

total contribution to the plan was allocated.\textsuperscript{10} There was a uniform relationship of benefits to compensation and a rather small maximum involved ($200). The court stated that it would not apply the "30% rule" as an absolute test for discrimination. Subsequently, the Treasury Department acquiesced to the court's decision, and agents ceased to apply it as an absolute for determining discrimination.\textsuperscript{11}

Inasmuch as the Commissioner may not test discrimination by looking to the application of money in the plan upon its entering the trust, may he look to the application of the money when the trust corpus is to be disbursed among the participants upon the program's termination. The answer, according to \textit{Ryan School Retirement Trust},\textsuperscript{12} is \textbf{No}, where it can be established that there is no conscious attempt to produce the end results. In that case, the plan which was the subject of consideration was a profit-sharing plan and not a pension plan, but the language of the court in reaching its decision would indicate that the results would have been the same had similar facts been presented with respect to a pension plan. At the time the Ryan School Plan was established, 115 employees of the school were eligible to participate, of whom four were officers and one a supervisory employee. At the time of the plan's termination, the number of persons included in the plan had dwindled to ten, five of whom were the original four officers and another the supervisory employee who had been in the plan from its existence. Profit-sharing plans customarily establish accounts to which are credited the annual share of the participant in a company's annual contribution, any appreciation (realized or unrealized) in trust value, and other equities. Participants usually vest in the accounts on a percentage basis, the amount in excess of the vested portion being forfeited upon termination of employment. The forfeitures are then distributed among the other accounts. Because of the extensive forfeitures involved, the five key participants in the original plan wound up with 58 per cent of all the money ever contributed to the plan, although only 8 percent of the money had at the time of contribution been allocated to them. However, while their accounts had increased by approximately 883 per cent, so had those of three other employees who had been included in the plan from its inception. Significantly, and referring to its earlier decision in the Volckening case, the court held that discrimination within the meaning of the statute does not result inevitably merely because there is a difference in the allocation of money to the key group as com-

\textsuperscript{10} When it published I.T. 3674, 1944 \textit{CUM. BULL.} 315, the service also published I.T. 3675, 1944 \textit{CUM. BULL.} 316, and I.T. 3676, 1944 \textit{CUM. BULL.} 317. Was I.T. 3676 issued with the Volckening case before it? The "hypothetical" facts in I.T. 3676 and the facts in the Volckening case both state that the two shareholder employees had allocated to them 58.3 per cent of the total contribution.

\textsuperscript{11} I.T. 4020, 1950-2 \textit{CUM. BULL.} 61, revokes I.T. 3674-3676.

\textsuperscript{12} 24 T.C. 127 (1955).
pared to the non-key employee group. Other language of the court is interesting because it notes that the Commissioner does not contend that there was a lack of bona fide. Unforeseen circumstances were stated to produce the result. The following passage from the court's decision is worth repeating.

We think that discrimination within the meaning of the statute embodies some real preferential treatment in favor of the officers as against the rank and file employees. That kind of discrimination is not present here, however, because ... no provision of the plan itself was inherently discriminatory, nor was there any ulterior motive to frame its provisions to channel the ... major part of the funds to the officer group because of any events or circumstances which the management foresaw or expected to occur. Furthermore, the original shares of the trust fund belonging to the 5 officers and the 3 rank and file employees who were continuous participants of the plan experienced the same rate of increase in amount over the 7-year period. Thus, the ratio between the shares of each such rank and file employee and each officer was the same as at the beginning of the plan.\(^5\)

The Commissioner has acquiesced in the decision.\(^14\) The result was to follow logically from the Volckening case, for if money is allocated properly during the plan’s operation, it would seem to follow that its allocation on termination also would be proper.

**Evaluation of the Interpretations**

Mimeograph 5717 does not provide that the restrictions it stipulates may be released or modified in case termination of a program is for certain reasons which could not be foreseen at the time of the plan’s adoption. It has been the experience of this writer that programs usually are terminated because of a merger or consolidation of one company with another or because of a drastic economic reversal in the business of the employer. Under such circumstances, the Commissioner has stated that he will not presume that the program was established on a temporary basis as contrasted with a permanent basis, or, more simply, that he will not presume a lack of bona fide ab initio with a consequent denial of deductions, etc. Curiously, it has not been expressly stated that this latitude in application of the rule applying to retroactive denial of deductions on early terminations will apply also to mitigate utilization of the rule to prevent “discrimination” in the amount of benefits to be distributed on early termination.\(^15\) Only on one condition may the plan terminate without applying the formula set forth in Mimeograph 5717; that is, where all past service costs have been fully funded.\(^16\) Therefore,

\(^5\) The Commissioner has acquiesced in the decision.

\(^14\) The result was to follow logically from the Volckening case, for if money is allocated properly during the plan’s operation, it would seem to follow that its allocation on termination also would be proper.

\(^15\) Only on one condition may the plan terminate without applying the formula set forth in Mimeograph 5717; that is, where all past service costs have been fully funded.

\(^16\) Therefore,
in essence, the Commissioner has stated that early termination of the plan is, ipso facto, discriminatory unless the formula set forth in Mimeograph 5717 is applied.

It is submitted that such a rule is not within the province of the Commissioner's making. In Commissioner v. Clark,\(^{17}\) the federal court of appeals had before it one of the so-called Clifford regulations which stated that under certain circumstances it would be presumed conclusively that the income from that trust was taxable to the settlor of the trust if by its terms the trust could last for less than ten (10) years. The court held that such arbitrary rule drawing, without looking to other facts, was not within the Commissioner's power. The Commissioner has since stated\(^ {18}\) that he will follow the Clark decision on the basis of similar facts. While short of acquiescence, this indicates a certain reasonable spirit on the part of the government. One could expect that if the court that considered the Clark case also had considered Mimeograph 5717 in determining whether the rules laid down by it were arbitrary, it would rule similarly. Would the Commissioner be as reasonable and allow latitude in the application of Mimeograph 5717?

If one applies the doctrine of the Clark case, he might make the following inquiries:

(A) On what basis has the Commissioner determined conclusively that the twenty-five highest paid persons in the employ of the company are highly compensated employees? The mere fact that they may be higher paid than other employees does not necessarily mean that they are highly paid, a term which it is submitted draws its meaning from broader standards than comparison of intra-company compensation. This fact was established by the legislative history. Section 144 of H.R. 7378 — the Revenue Act of 1942 as it passed in the House — provided that a plan would not be discriminatory if the contributions or benefits would not have the effect of discriminating in favor of any employer whose compensation is greater than that of other employees.\(^ {19}\) Subsequently, the provision was amended by the Senate to provide that the program would not be discriminatory if the contributions or benefits do not discriminate in favor of highly compensated employees. It is submitted that the change from the comparative "greater" to the term "highly" imposes invoking a broader standard than comparative intra-company pay scales.

(B) On what basis has the Commissioner determined that one whose anticipated annual pension is $1,500 or more is highly

\(^{17}\) 202 F.2d 94 (7th Cir. 1953).


\(^{19}\) INT. REV. CODE OF 1939, as amended, § 165(a)(4).
compensated? Perhaps the Commissioner has attempted to answer the objection in (A) above by providing as a standard that anyone whose anticipated annual pension will exceed $1,500 is highly compensated inasmuch as a pension is normally the function of the man's income, and the higher his income, the larger his pension. Nevertheless, this is not always the case, and there are certainly many plans where many modestly paid persons may anticipate receiving pensions in excess of $125 per month where their service is long and the pension formula determines that the benefit is computed by multiplying a percentage of pay times years of service. The arbitrary nature of the formula is readily discernible, for a monthly pension of $125 may be based upon a salary of any figure at all. In short, a salary sufficient to produce a pension of that size does not have to be large. Furthermore, the basis of compensation does not have to be a salary. Many union plans covering wage earners produce pensions of that size. Besides, a salary in 1960 sufficient to justify a pension of $125 may be high by 1944 standards, but can, by 1960 standards, be low.

(C) How has the Commissioner determined that twenty per cent of the first $50,000 of average regular annual compensation multiplied by the years of the plan's continuance produces such an allocation of benefit as does not result in discrimination?

(D) From what source does the Commissioner arbitrarily draw the period for his application of the rule to be the first ten years after the plan's inception? Certainly this practice violates the Clark case on its face and yet the acquiescence in the Clark case states that the Commissioner will follow it under similar circumstances.

(E) Is the Internal Revenue Service correct in its presumption, on which it bases the rule set out in the Mimeograph, that a plan must be permanent to be a "plan" within the meaning of the word as used in the statute. The dissenting judges in Lincoln Elec. Employees' Profit-Sharing Trust v. Commissioner20 refused to accord such a meaning to the term, and in reversing the decision of the Tax Court, the Sixth Circuit Court of Appeals agreed. The criterion, said the court, is whether the plan adopted promotes the statutory scheme contemplated by Congress.21 It is submitted, however, that this fact cannot be determined in advance by the publication of rules like Mimeograph 5717, but only upon termination of the plan.

(F) Finally, does not the rule draw attack from its failure to restrict its application to a group composed of those in whose favor a qualified plan may not discriminate? Because one merely anticipates an annual pension of $1,500 does not mean that he is a stockholder, supervisor, or executive — classifications fixed by statute.

TREASURY PS 50

Can Mimeograph 5717 be circumvented by originally making a provision for benefits computed at a low rate and then later amending the plan so as to increase the benefits substantially? The answer is, and quite logically should be, NO. Paragraph 7 of Mimeograph 5717 states that

where a plan or its funding method has been changed so as to increase substantially the extent of possible discrimination as to contributions and as to benefits actually payable in the event of subsequent termination, the change will be considered as the establishment of a new plan and the conditions of the rule set forth in this Mimeograph 5717 are to apply by substituting the date of the change for the date of the establishment.

A year after the publication of Mimeograph 5717, the Service published Treasury PS 50 which amplified paragraph 7 of the Mimeograph. The Service stipulated that when benefits are increased substantially, there might be substituted for the limits set forth in Mimeograph 5717 a limit which cannot exceed the greatest of the following three amounts:

1. The employer's contributions which would have been applied to provide the benefits for the employee if the plan had continued without change;
2. $20,000;
3. The sum of (a) the employer contributions which would have been applied to provide the benefit for the employee if the plan had been terminated one day before the effective date of the change, plus (b) an amount computed by multiplying the number of years for which the current costs of the plan after the date of change have been met by 20 per cent of the first $50,000 of average regular annual compensation.

22. The Service has not stated what will be regarded as a substantial increase. An increase in the minimum benefit under a plan usually has not required the inclusion of clauses to implement PS 50 because an increase in the minimum reduces the hazards of discrimination. An increase in pension resulting from a reduction in the amount which is taken as an offset from a regularly computed pension also will not require, usually, the invocation of the restrictions of PS 50. On the other hand, Treasury Department agents have held that an increase resulting from the elimination of clauses to implement the "30% rule" will require the invocation of the rule, even though the "30% rule" itself was invalid and even though provisions invoking the "30% rule" had to be added to the plan by amendment.
Table I illustrates the application of the rule in a fully insured retirement plan; that is, one where all benefits are provided by purchase of insurance company contracts. Mr. Executive, at the time of the amendment to the plan in 1952, earned $15,600 — a large but hardly staggering sum — and was included among the highest twenty-five paid persons covered by the plan. His new anticipated monthly benefit is $460 — the new maximum benefit under the plan. He also was entitled to the maximum under the plan before it was amended. To fund his benefits, two contracts had been acquired for his benefit: the first in 1950 to provide (assuming continued maintenance of the plan) a monthly benefit equal to the originally established maximum monthly pension under the plan, and the second in 1952 to provide the increment in the maximum. In discussing the restrictions applicable to him, it is helpful to use the term “unrestricted maximum” in referring to the largest sum Mr. Executive may withdraw from the plan should it terminate while the restrictions apply. This amount always will be the smaller of (a) the cash value of his benefits and (b) the largest amount computed according to formula under Treasury PS 50.

A comparison of lines 12 and 19 will indicate the years in which the restrictions have no practical effect. Where line 12 exceeds line 19, the excess is forfeitable should the plan terminate in the period shown in the column established by headings in line 7 and the amount forfeited is shown in line 20. From 1954 onward, the restrictions apply in ever increasing amounts. To guard against total disbursement of vested values which exceed the unrestricted maximum on line 19 and thereby circumvent the restriction, it becomes necessary for the trustee to retain control of the excess or, pursuant to Revenue Ruling 61-10,23 receive an agreement from Mr. Executive to indemnify the trust for the excess should the trust terminate while the restriction applies but after disbursement. Because of the limited number of years of Mr. Executive’s employment, his vested interest on termination of employment is always lower than the value of his benefits, with the result that it is not until 1956 that the restriction has any practical effect upon his vested values. Should employment terminate in any year after 1955, the restricted balance is shown on line 22, while line 23 shows the number of years it will take to recover the retained balance if the plan continues. The restricted balance is recoverable as the plan proceeds because the unrestricted maximum increases each year that the plan continues; as it increases, the difference between the amount disbursed before computation and the new unrestricted maximum may be disbursed or, alternatively, the amount subject to indemnification may be reduced. Since one of the principal advantages of a qualified plan is to treat as a capital gain any

### TABLE I

1. Date of Mr. Executive's Employment
2. Effective Date of Plan
3. Effective Date of Amendment to Employees' Retirement Plan
4. Normal Retirement Date
5. Monthly Pension at Normal Retirement Date Under Amended Plan
6. Vested Interest In Contracts Prior to Normal Retirement Date

<table>
<thead>
<tr>
<th>Years Considered</th>
<th>1952</th>
<th>1953</th>
<th>1954</th>
<th>15</th>
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7. TWELVE MONTHS
8. Number Years Since Effective Date | 2    | 3    | 4    |
9. Number Years Amend. | 0    | 1    | 2    |
10. Cash Value — 1st Contract | $7,935.07 | $12,477.81 | $17,190.74 | $22,015.30 |
11. Cash Value — 2nd Contract | $7,935.07 | $12,477.81 | $17,190.74 | $22,015.30 |
12. Total Cash Value | $15,870.14 | $24,955.62 | $34,381.48 | $44,030.60 |
13. % Vested Interest* | 40%  | 45%  | 50%  | 55% |
14. Vested Interest | $3,174.03 | $6,556.51 | $11,007.65 | $16,615.26 |
15. 20% of Average Compensation for 5 Years | $3,024.00 | $3,048.00 | $3,072.00 | $3,096.00 |
16. Item (1) | $7,935.07 | $12,477.81 | $17,190.74 | $22,015.30 |
17. Item (2) | $20,000.00 | $20,000.00 | $20,000.00 | $20,000.00 |
18. Item (3) | $10,983.07 | $14,079.07 | $17,175.10 | $20,271.14 |
19. Unrestricted Maximum | $7,935.07 | $12,477.81 | $17,190.74 | $22,015.30 |
20. Forfeiture | 0    | 0    | 0    | 0    |
21. Reduced Pension | NOT APPLICABLE |
22. Restricted Balance | 0    | 0    | 0    | 0    |
23. Years to Recover Balance | 0    | 0    | 0    | 0    |
24. Total Forfeiture | 0    | 0    | 0    | 0    |
25. Cumulative PS 58 Cost | $632.00 | $1,318.00 | $2,004.00 | $2,690.00 |

*Contracts are fully vested on termination of the Plan. Figures in this column refer only to vested interest in event of termination of employment prior to Normal Retirement Date.
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</tbody>
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large disbursement from a qualified plan, and because the capital gain
treatment will apply only if the total distributions payable to Mr. Execu-
tive are paid to him within one taxable year on account of his termina-
tion of employment, the indemnification agreement becomes important;
for disbursement over several years will vitiate entitlement to a capital gain.

Reference to line 21 under columns “1961” and “1962” also is im-
portant. Where termination of the plan occurs, retirement benefits are
reduced to an amount determined by multiplying the monthly pension by
the ratio that the unrestricted maximum bears to Total Cash Value in line
12. Beginning October 10, 1960, the unrestricted maximum becomes
$49,197 — the cash value of the first acquired contract arising by pay-
ment of the premium due October 10, 1959. This reflects the amount
which would have been payable on and after October 10, 1960 (cf. line
16 under column 1961) had the plan continued without change; that is,
the unrestricted maximum determined by applying the first item in se-
quence of the three set forth in the formula established under PS 50. The
value of the benefits on October 10, 1960, by reason of payment of the
premium on October 10, 1959, is increased by $23,805 (line 12 under
1960) to a total of $73,002. Multiplying the expected pension of $460
by the ratio of $49,197 over $73,002 produces the $310 result on line
21. Since neither the unrestricted maximum nor the value of the bene-
fits increases after 1961, the monthly benefit for Mr. Executive would
not increase even though contributions by the employer would have
continued.

If one accepts the questionable premises upon which Mimeograph
5717 is predicated, the rule in Treasury PS 50 can be tolerated during
the first ten years of the plan’s existence under the aegis that during that
time, the plan is in a probationary period to establish the merits of its
having been adopted. Once the first ten years have elapsed, however,
it is submitted that the rule should be somewhat different because of the
lapse of the first probationary period. As shown by Table I, there is no
improvement in Mr. Executive’s condition despite the continuation of the
plan by his former employer — a result which seems somewhat inequit-
able. Comparing the inequitable result with the rules of the Treasury
Department only adds illogic to the inequitability, and comparing the
Department’s attitude toward two plans adopted by the same employer
to cover the same group only compounds the illogic, as will be shown in
the two succeeding paragraphs.

In Revenue Ruling 55-60, the Service held that where a plan ter-
minated after having been in operation more than ten years, a material
variance in the percentage of assets distributed to persons within the
group to which discrimination is prohibited on the one hand, and to all
other employees on the other, would not result in discrimination under
the statute. This substantiates the theory of "initial probation" as the basis for Mimeograph 5717 and the further basis for believing that a "period of second probation" should attach to the plan after it has been amended, with somewhat different rules applying when the period of "initial probation" expires.

The Treasury Department has not insisted on applying a formula of the type required by PS 50 upon the total benefits under two plans where one was adopted after the effective date of an earlier one. It is therefore possible to find that, where an employer adopts one plan in one year and a few years later adopts a second plan, there will be employees under the two plans who will receive annual benefits in excess of $1500, but will not receive that amount of benefits under either plan separately. In the event of simultaneous termination of both plans, no restrictions would apply to either, whereas if the earlier plan had been amended to provide for the increase in benefits, the restriction might apply. Perhaps the answer to the inconsistency may be rationalized by asserting that discrimination on termination of the plan is to be tested with respect to each plan individually, not jointly,24 and perhaps another answer may be the fact that paragraph 7 of Mimeograph 5717 itself states that the increase may be regarded as the adoption of a new plan — hence, clauses implementing Mimeograph 5717 in each should suffice.

The effect of the government's position on not requiring restriction clauses regarding the combined benefits under two plans is, referring to Table I again, that if there had been two plans instead of one, Mr. Executive would not have been restricted under either plan on and after October 10, 1960. Under plan I, Mimeograph 5717 would have lapsed. Under plan II, the application of Mimeograph 5717 restrictions would have produced an amount which exceeds the value of the increased benefits. Under column 1960, eight years since adoption of amendment (line 9), times $3,120 (line 15) equals $24,960, which exceeds the value of the second contract of $23,805 (line 11). While there would be difficulty in qualifying plan II to revise because of the limited group it would cover, it would by no means be impossible. It is only logical, therefore, to suggest that after the period of initial probation has expired, the restriction during the balance of the "period of second probation" ought to be computed so as to accord with the "establishment of a new plan" theory under paragraph 7 of Mimeograph 5717 as follows:

(a) What the individual would have been entitled to receive at the time of termination had the plan continued on in effect one day before the change, plus:

(b) The larger of (1) $20,000, or (i) 20% of the first

24. Cf. § 401(a) of the Internal Revenue Code of 1954 and PS 27 which speak of referring to two plans to establish qualification of both.
$50,000 of average regular annual compensation multiplied by the number of years since the date of change, but neither to exceed the actuarial value of the increment.

Of course, the opinions set forth previously relating to the invalidity of Mimeograph 5717 apply with equal force with respect to Treasury PS 50.

**Corollary Rulings and Rules**

Following the publication of Mimeograph 5717, several questions were directed to the Internal Revenue Service concerning how the rule should be applied. As noted above, Mimeograph 5717 was published July 13, 1944. Scarcely a month later, on August 4, 1944, the Service published Treasury PS 8. The Service, in response to a request for a universal test which would meet the requirements of Mimeograph 5717, stated that no particular clause would be necessary, but then gave an example as to what would be satisfactory. A few months later, on November 11, 1944, the Service published PS 42, stipulating that a clause inserted in the plan stating that benefits distributed from it should not exceed the amounts permitted by Mimeograph 5717 would not be satisfactory since it would be too indefinite. In the same PS, the Service refused to set forth an acceptable standard provision applicable to all pension and annuity plans. In paragraph 2 of PS 42, the Service considered the acceptability of a clause which in addition to restricting disburseable funds to the amounts stipulated by the formula prescribed by Mimeograph 5717, further stated that if greater than the restrictions, the amounts disburseable could equal "(3) the amount which may be allowable under the applicable laws and regulations in force at that time." The Service refused to accept this because the limitation was not specific. The Service, however, curiously enough sanctioned what the draftsmen really wanted to accomplish by stating that it would approve a plan which in addition to containing the specific limitation would further include the limitation to the effect: "in the event the Commissioner of Internal Revenue later rules that the limitation is no longer necessary for the plan to meet the requirements of section 165 (a) or other applicable provisions of the Internal Revenue Code then in effect, the limitations shall not longer apply." While one might argue that this is tantamount to an admission on the part of the Commissioner that his rule in Mimeograph 5717 may lack validity, it could be argued with equal force that the Commissioner’s position is one of reasonableness to avoid a multitude of amendments which could occur in the event a rule would be declared inapplicable and would create an administrative burden by reason of requests to pass on continued qualification.
The most prevalent type of plan in force at the time of the publication of Mimeograph 5717 was that of the individual policy type under which death benefits are provided for insurable participants by insurance in an amount equal to 100 times the anticipated normal monthly pension. Normally, death benefits under such policies are provided after retirement so that the covered employee will receive a guarantee of his payment of his pension for at least ten years after retirement, with the result that should he die within those first ten years after retirement, the balance of the payments will continue to the end of the ten year period to his beneficiary. Paragraph 9(c) of Mimeograph 5717 provided that the term "benefits" within the scope of Mimeograph 5717 include periodic income and withdrawal values and the cost of death benefits payable after retirement, but included neither the cost of any death benefit before retirement nor the amount of any death benefit actually payable after the death of an employee, whether such death occurs before or after retirement. The subject of these death benefits was a topic of further consideration under PS 29, published September 16, 1944. In PS 29, the Service ruled that employer contributions to provide death benefits prior to retirement should be excluded from the employer contribution subject to the conditions indicated in paragraph 3 of Mimeograph 5717.

It is to be noted that the employee pays a tax equal to the term cost of the death benefits providable under any of these programs. It is to be further noted that pursuant to section 72(d) of the Internal Revenue Code, an employee who receives benefits from a qualified employees' plan pays no tax upon the monthly installments which he receives provided that he is able to recover his own contributions within three years. Furthermore, it is to be noted that in section 72(f)(1) of the Internal Revenue Code, an employee who receives benefits from a qualified employees' plan pays no tax upon the monthly installments which he receives provided that he is able to recover his own contributions within three years. Furthermore, it is to be noted that section 72(f)(1) of the Internal Revenue Code provides that the amounts which the employee included in his income are construed to be contributions which he has made to the plan so that the amount which he paid tax for the cost of insurance protection operates as a credit under section 72(d) of the Internal Revenue Code. It has been suggested by some that it is not proper to apply such credit inasmuch as the cost of current insurance

26. Cf. examples (1) and (2) under Treas. Reg. 1.402(a)-1(a)(4)(iii) (1956), as amended, T.D. 6485, 1960-2 CUM. BULL. 28, as amended, T.D. 6497, 1960-2 CUM. BULL. 19, which demonstrate that the term cost of insurance protection which has been included in income may be applied in reduction of the cash value subject to inclusion in gross income under either section 402 or section 72.
protection is a current term cost for a value that leaves no residue for future set off. However, the Internal Revenue Service regulations have not followed this theory in applying section 72(f)(1). If one applies the same theory in the application of Mimeograph 5717 and Treasury PS 50, as amplified by PS 29, the result is a reduction in the amount subject to restriction in the typical insured plan. It is only logical to accept such a reduction as being consistent with the rules which reduce the amount of a distribution subject to tax by the amount equal to the cost of protection previously included in income. This position is strengthened by the fact that Mimeograph 5717 and its corollary rulings always have been understood to exclude from restriction any amounts contributed by the employee. An amount upon which the employee has paid a tax should be considered the equivalent of a contribution by him, even though in insurance theory, the value arising by such an amount cannot be construed as having a later cash value.

The practical effect of so applying PS 29 may be understood by referring again to Table 1. The values on the Table have been computed by using data applying to retirement annuity contracts, which do not provide insurance, rather than retirement income contracts which provide insurance equalling 100 times the expected monthly pension at retirement. Assuming, however, that the values of the two types of contracts were identical (which they are not) and that Mr. Executive is insurable, the cumulative term cost for $46,000 of his insurance (100 times his expected monthly pension of $460) is shown on line 25. (For further simplicity, amounts included in income before 1953 are excluded from the Table.) These amounts would be applied in reduction of the forfeiture on line 20 or line 22, whichever applies.

As indicated earlier, there are many plans which are not funded on a basis whereby there are individual allocation of contributions. Nevertheless, early termination of such a program requires computations involving segregation of assets upon termination. In lieu of restricting the contribution of the employer which could be distributed to the employee,

27. PS 29 further provides that the cost of death benefits to provide survivorship benefits after retirement are to be included in determining the amount of employer contributions which may be disbursed. In PS 29, examples are cited of the maximum amount of employer contributions which may be disbursed. In PS 29, examples are cited of the maximum amount of employer contributions which may be used to provide an employee with his unrestricted benefits. The major topic of PS 29 is a consideration of optional methods of payment and not the subject of pre-retirement death benefits.


29. Note that the inclusion of amounts in the income of Mr. Executive begins in 1953, one year after the protection has begun. Technically, the inclusion could have begun in 1952 when the premium for one year's protection has been paid. Most taxpayers prefer, however, to defer the date of income inclusion until the protection has been in force a full year.
PS 38 considered the level of benefit which could be paid to an employee participant after the plan's termination, phrasing the restriction in terms of the amount of monthly benefit which could be paid after termination rather than in the terms of lump sum values. The clause referred to in PS 38 stipulated that the annual benefit could equal the greater of (a) $1,500, or (b) an amount equal to 1.75 per cent of the first $50,000 of his average regular annual salary plus in either case 1/15th of the aggregate contribution made to the plan by the participant himself. While approving the formula, the Service stipulated that if the retirement age were 60 instead of 65 the factor of 1.50 per cent should be substituted for the 1.75 per cent, and if the retirement age is 70 the factor of 2.25 per cent should replace the 1.75 per cent. Without explaining its reasoning, it is to be assumed that the Treasury Department determined that 20 per cent of the first $50,000 of aggregate average regular compensation at a particular age would produce a benefit of approximately 1.75 per cent. However acceptable the formula in PS 38, there are comparatively few plans which have ever used it. In the antepenultimate paragraph of the ruling, the Service states that the provision is applicable to a plan of the “self-insured” type (i.e., no insurance contract used) where there are no allocations of individual employer cost.

**CONCLUSION**

Before leaving the subject of Mimeograph 5717, a few comments appear to be appropriate as to the climate in which it was adopted. The Service foresaw in 1944 possible discrimination at the inception of the Plan, against which it sought to guard by the “30 per cent” rule; discrimination in terms of the plan's operation where benefits were limited to a percentage of an excess portion of salary, against which it sought to guard by so-called integration rules; and discrimination at termination of the plan against which it sought to guard by the “termination rule.” It must be remembered that in 1944, the nation was at war and was realizing a degree of prosperity which it had not enjoyed for some 15 years. Evidence of this psychology is found in PS 52 where the Service considers, in its words, the case of a “marginal” producer who for 25 years prior to the adoption of its plan averaged a profit of $10,000, and in no year prior to 1940 did its profits exceed $15,000 per year. Profits in 1940, according to the example, increased to $20,000; in 1941 to $50,000 and to $150,000 in 1942. When the Plan was adopted in 1942, the company visualized excellent post-war opportunities. In 1945, however, the profits dropped to $50,000, and in 1946, in the example set by the Service in 1945, the post-war prospects were not favorable and it appeared that the company would have little or no profits in 1946 if it
continued to make the $15,000 contribution required by the Plan. Just a few words cited indicate that the Service was concerned with the so-called “war-baby” which would adopt the plan for a short period of time during its lush war years to siphon money away from the tax coffers and then abandon the plan. The economic history of the nation in the 15 years which have followed World War II have not justified the fears of the Treasury Department based on the 15 year history that preceded publication of Mimeograph 5717. There have been comparatively few pension plans terminated in the years which followed the war, and as a matter of fact the number of plans which have since been installed has far exceeded the number which have been terminated. Moreover, more years than ten have elapsed since the date that Mimeograph 5717 was published and, furthermore, more years than ten are about to elapse since the year 1950 when great impetus was given to the establishment of pension programs via the route of union negotiation. Mimeograph 5717, therefore, and its ancillary rulings should be viewed merely as an attempt on the part of the Treasury Department to guard against a result which the Service feared at the time the rule was published — a result, to be remembered, that was felt to be in violation of the statute.

Despite the fact that the Treasury Department has asserted that the rule may be removed from a plan in the event that court decisions or subsequent rulings of the Commissioner revoke the rule, it is not easy to challenge the rule judicially. Challenging the rule in court is a difficult process for (a) a corporate taxpayer would have to delete the clause from a plan, terminate the plan, and then litigate, if the department chose to do so, a denial of deductions (hardly a pleasant prospect) or (b) one entitled to restricted benefits from the program would have to challenge the authority of the rule by suing the trustee for withholding benefits rightly due him. The failure, therefore, of a court’s having entertained a case involving the propriety of the rule ought not to be taken as tacit acquiescence of the taxpayers to the rule, but rather as tribute to the difficulties of obtaining judicial review. While it would be hoped that the Internal Revenue Service would reverse its position, this is not likely to occur, and it probably will remain necessary for someone to undertake reversal of the rule.

The history of pension programming since the promulgation of Mimeograph 5717 clearly indicates that it should be withdrawn, for that history has clearly shown that pension programs are not set up as collapsible enterprises but rather as permanent ones that die for good reason. No better statement of the principles upon which the rule could be withdrawn could be found than in the text of Revenue Ruling 55-60, where the Service held that a disproportionate distribution after a plan had been in effect ten years was not discriminatory, but merely the re-
suit of a fortuitous set of circumstances which were not of themselves discriminatory. It is submitted that termination of a plan within the first ten years of its operation can arise from circumstances which are as fortuitous as those which could occur afterward, and that reference to ten years duration is an arbitrary standard. Let us accept the rule for what it was in its main facets — a notice to those in control of the destinies of a corporation and its plan that a danger lurks in early termination; an answer to sincere agents who saw an evil; an attempt to learn what the rule was; a brake upon a tax loophole in the eyes of some — and put it to rest.