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IMPACT OF TAXES ON INDUSTRIAL PENSION PLANS

By
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INDUSTRIAL RELATIONS COUNSELORS
Incorporated

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Established May 1, 1926, Industrial Relations Counselors, Inc., superseded the industrial relations staff of the law firm of Curtis, Fosdick and Belknap, which began work in January, 1922. The organization operates on a nonprofit basis in accordance with the terms of its charter. Its purpose as expressed in the certificate of incorporation is "to advance the knowledge and practice of human relationships in industry, commerce, education and government." To this end it carries on research in industrial relations, makes surveys of the industrial relations policies and methods of individual companies at their request, offers consulting service, maintains a specialized industrial relations library and an information service concerning activities in industrial relations and personnel administration. In its research work Industrial Relations Counselors, Inc., seeks to accumulate and analyze the experience of this and other countries in certain significant aspects of industrial relations and to present the findings in an unbiased way.

A list of the studies published by Industrial Relations Counselors, Inc., is given at the end of this monograph.

FOREWORD

In aiding some hundreds of industrial companies, governmental agencies and educational institutions during the past fifteen years to devise and reconstruct retirement systems, Industrial Relations Counselors, Inc., has been increasingly conscious of the growing importance of tax considerations in pension planning. Changes in federal tax policy have altered the course of thinking and practice of many managements. Persons of long experience in this important area of industrial relations doubt whether the long-run interests of employees have always been served. For example, they may not have been served by the wartime development of an unprecedented number of noncontributory plans, reversing, solely by reason of tax advantages derived, a twenty-year trend toward the contributory procedure. At some points Treasury policy raises issues of equity, as in the taxation of employee contributions and the exemption of employer contributions. Should federal policy be revised and, if so, in what directions?

Industrial Relations Counselors was fortunate in securing Rainard Robbins to undertake this study of the impact of taxes on pension plans. Mr. Robbins, an actuary of high repute, has served the Teachers Insurance and Annuity Association of America for many years. His professional standing and experience commend his findings to the careful consideration of all concerned with the shaping of pension programs for the better through federal tax policy. Opinions expressed by the author are not necessarily those of Industrial Relations Counselors.

BRYCE M. STEWART,
Director of Research

New York City, February 1, 1949

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IMPACT OF TAXES ON INDUSTRIAL PENSION PLANS

I. DEVELOPMENT OF INDUSTRIAL PENSION PLANS

Status in 1925

In 1925 the National Industrial Conference Board made a study of pension plans "operative in private, industrial, mercantile and financial establishments." The report[1] aimed to include all such plans and lists 248, counting as a single plan those of subsidiary members of a parent or holding company. The dates of adoption of these plans are indicated as follows:

Period of Establishment	Plans Operating in 1925
Before 1885	1
1885–1890	1
1891–1895	1
1896–1900	2
1901–1905	16
1906–1910	26
1911–1915	73
1916–1920	68
1921–1925	40
Not reported	20
Total	248

While the total number of employees covered was 2,815,512, twenty-nine of the plans were in companies having more than 2,000,000 employees and four plans—those of the United States Steel Corporation, the American Telephone and Telegraph Company, the Pennsylvania Railroad System, and the New York Central Lines—accounted for 945,236 of these. The railroad plans alone applied to 1,181,509 employees, or more than 40 per cent of the total.

As to financing in 1925, this study remarks: "A careful estimate of probable costs of a pension scheme is an essential preliminary to sound financing. Traditionally, this procedure has not been followed and even today *the majority of schemes rest on a merely empirical or hand-to-mouth basis of appropriations sufficient merely to meet current demand.*"[2]

Also bearing on this point is the fact that of the 248 plans, 168 were of the "noncontributory discretionary" type under which an employee had no

[1] National Industrial Conference Board, *Industrial Pensions in the United States*, New York, 1925, 157 pp.

[2] *Ibid.*, p. 21. (Emphasis in text supplied by author.)

semblance of a right to a benefit, as is indicated by a clause given as typical of such plans: "It is also expressly understood that every pension hereunder will be granted only in the discretion of the company, will be continued only at its pleasure, and may be revoked by it at any time."[3]

The mere number of plans of this kind is not conclusive as to the prevalence of this method in terms of individual employees affected. However, an appendix tabulation listing the plans shows that more than 2,000,000 employees, i.e., over 70 per cent of the total, were covered by plans of this type. This group included all railroads of any prominence. It may be of interest to note that when the federal government took over all the pensions being paid under the railroad plans in 1937, up to $120 a month in any one case, no transfer of funds was made by the railroads to the government to pay these pensions. In fact, reserve accumulations on the part of the railroads for pension plans were never substantial as related to the prospective outlays, except in the case of one small road, and during depression years before 1937 some prominent roads reduced pensions that had already been started.

Rereading this 1925 publication of the National Industrial Conference Board in the light of developments since that time emphasizes the fact that in general the industrial organizations which held out the prospect of pensions to employees (1) were careful to see that they were not bound financially by their announcements, (2) neglected systematic funding to meet pension outlays, and (3) made little use of anything so protective as annuity contracts or an inviolable trust fund for whatever may have been set aside in anticipation of pension payments.

These elements of the prevailing attitude at that time were consistent. To have been scrupulous about systematic funding or about safeguarding funds meticulously for pension payments would have been inconsistent with careful insistence that the organization could be almost capricious about such payments. It is not surprising, therefore, that no mention is found in this study of any relation between taxation or tax exemption and preliminary funding for pension payments; nor are pension trusts mentioned except in the board's suggestions for future administration of pension plans. Here individual reserves on behalf of every employee are suggested, these to correspond to periodic investments on the part of the employer of definite amounts "which may be a fixed percentage upon the employee's wage or salary. The amount thus set aside should form a trust fund which cannot be diverted to other uses while the employee remains on the active or on the pension roll."[4]

[3] National Industrial Conference Board, *Industrial Pensions in the United States*, *op. cit.*, p. 49.
[4] *Ibid.*, p. 135.

That employers were not generally ready to part with close supervision and control of their pension plans is indicated as follows:

> The great majority of industrialists, on the other hand, are still disinclined to relinquish direct control over the investment and management of their pension funds. Viewing their pension plan as a means to improving industrial relations in their establishments, these employers wish to prevent the operation of that plan from falling into impersonal routine and thereby losing the human touch and flexibility. For similar reasons they wish to preserve something of the discretionary character of the plan itself. The intervention of an outside agency is, therefore, unwelcome, inasmuch as it makes for an inflexible and more or less automatic operation of the system.[5]

Status in 1929 and 1932

In 1932 Industrial Relations Counselors, Inc., published a comprehensive analysis by Murray W. Latimer of industrial pension plans, which shows their status in June, 1929, and in May, 1932.[6] This study covered plans in both the United States and Canada. As to date of establishment of plans operated in 1929, it gives:

Period of Establishment	Plans Operating in 1929
1874–1900	8
1901–1905	23
1906–1910	29
1911–1915	100
1916–1920	126
1921–1925	74
1926–1929	58
Total	418

From July 1, 1929, to April 30, 1932, sixty-nine new plans were established and forty-five plans were discontinued. A number of plans were discontinued because of mergers and some were closed to new entrants. This makes it difficult to trace with certainty the year of establishment of plans operating in 1932; as the present writer interprets Latimer's data, the 1932 status was as follows:

Period of Establishment	Plans Operating April 30, 1932
1874–1900	8
1901–1905	22
1906–1910	27
1911–1915	88
1916–1920	114
1921–1925	66
1926–1929	48
1930–1932	69
Total	442

[5] National Industrial Conference Board, *Industrial Pensions in the United States, op. cit.*, p. 120.
[6] M. W. Latimer, *Industrial Pension Systems in the United States and Canada*, New York: Industrial Relations Counselors, 1932, 2 Vols.

Latimer reported that, in 1929, 360 of the 418 plans covered a total of more than 3,745,000 employees; in 1932, 398 plans reported less than 3,733,000 employees. The decrease in coverage doubtless reflected effects of the depression. As in 1925 a large majority of employees covered by pension plans were employed by a relatively small number of large corporations. While the number of pension plans increased markedly, the new plans were in relatively small concerns. The new plans for the period 1926-1929 covered some 175,000 employees, while, of the sixty-nine new plans for the period 1929-1932, the fifty-nine for which figures were available had normal employment of less than 36,000 employees.[7]

In 1929 at least 3,580,000 employees were in companies with noncontributory plans, while, of the eighty-six contributory plans, the seventy-three for which data were available applied to 146,463 employees. Latimer states that, in 1928, of the companies with noncontributory plans, forty-one had established trust funds, sixty-three had established balance sheet reserves for pensions, two plans were completely insured, and two were partially insured.[8] He adds, however, that pension trusts covered only 27 per cent of the employees under noncontributory plans and that "examination of the trust funds shows that most of them had been accumulated through no set method of financing" and a substantial part of the trust funds were subject to recapture upon short notice. Only one trust was "absolutely irrevocable."

During the period 1929-1932, the trend definitely was toward contributory and reinsured plans. Of the sixty-nine new plans, sixty-two were contributory and all but one were reinsured. As already noted, these plans were in relatively small companies.[9]

Pension trusts were of sufficient interest in 1932 to result in a somewhat detailed description in Latimer's book. The bearing of federal income tax on pension plans was reflected by a review of the provisions of the 1928 Revenue Act and related regulations, but there is no indication in the book that these were having any noticeable influence on the development of retirement plans. It should be borne in mind that this was fairly early in the depression years, that tax rates were low compared with those ten years later, and that the employment market required little initiative on the part of the employer.

Status December 31, 1938

In 1940 Industrial Relations Counselors, Inc., published a review of plans established or revised after Mr. Latimer's earlier analysis and down to December 31, 1938.[10] This study covers only United States plans and

[7] M. W. Latimer, *Industrial Pension Systems in the United States and Canada*, *op. cit.*, pp. 472-477, 483, 842, 844.

[8] *Ibid.*, pp. 48, 615.

[9] *Ibid.*, p. 850.

[10] M. W. Latimer and Karl Tufel, *Trends in Industrial Pensions*, New York: Industrial Relations Counselors, 1940, 88 pp.

excludes all railroad plans on the ground that most of them ceased to function when the Railroad Retirement Act came into full effect in 1937. It found trace of 281 plans established since the previous study that were still active and a total of 515 plans "known to be operating at the end of 1938." Of this total, 383 plans reported coverage for 1,693,718 employees.[11]

While more than 75 per cent of all plans were contributory, these covered only 29 per cent of the employees because many of the largest companies continued with their noncontributory plans.

This study refers to the facts as to employer deductions in calculating federal income tax of sums set aside for pensions, but gives no evidence that plans were being affected or that the tendency to establish pension plans was being influenced to a substantial extent by these facts. A distinction between the treatment with respect to taxation of payments to a large insurance company and payments into a trust fund is emphasized as follows:

> The federal income tax legislation, however, makes an important distinction between payments to a trust and payments to an insurance company. Whereas all payments to the latter, if reasonable, may be deducted from income for the year in which the payment is made, payments to a trust on account of deferred past service pensions must be deducted in equal instalments over a period of ten years. The rulings on payments to an insurance company are based on the general provision that deductions may be made for all reasonable and necessary expenses of carrying on a business. Payments to a trust, however, are controlled by a special provision in the income tax law, which was intended to deal with a specific situation but now governs all cases. There is even less warrant for the differential treatment as between trusts and insurance companies than when the special trust rule was enacted, since pension trusts are now subject to more rigid requirements than formerly.[12]

Status August 31, 1946

The growth in the establishment of pension plans has been so rapid in recent years that apparently no private organization has attempted a complete census. The Internal Revenue Bureau, however, has recently released interesting statistics regarding profit-sharing and pension plans, approved under Section 165(a) of the Internal Revenue Code up to the end of August, 1946. From these are extracted the following data on pension plans with respect to which favorable rulings were issued as to qualification under Section 165(a), processed through August 31, 1946:

[11] M. W. Latimer and Karl Tufel, *Trends in Industrial Pensions*, *op. cit.*, pp. 7, 47.
[12] *Ibid.*, p. 40.

Period in Which Plan Became Effective	Number of Plans	Number of Participating Employees	Total Employees	Annual Payroll of Participating Employees (In Thousands of Dollars)	Annual Employer Contributions	
					Amount (In Thousands of Dollars)	Percentage of Payroll
Before 1930	105	1,394,184	1,794,080	$3,155,418	$124,174	4
1930—1939	517	530,606	1,307,562	1,732,753	116,789	7
January 1, 1940—September 1, 1942	843	450,008	2,156,181	1,388,928	82,610	6
September 2, 1942—December 31, 1944	4,208	714,681	3,579,857	2,143,140	221,708	10
1945 and 1946	1,189	201,129	825,841	624,211	107,939	17
Total	6,862	3,290,608	9,663,521	$9,044,450	$653,220	7

These figures show clearly the rapid growth of pension plans in recent years, especially during the two years following September 1, 1942. It is also of interest that the average coverage of earlier plans is much larger than that of the later ones. The figures in the last column to the right (added by the present writer) indicate that under recently established plans the contributions are more than four times as large, as a percentage of payroll, as they were under plans established prior to 1930.

From another table of the Internal Revenue Bureau's statistics we extract the following distribution with reference to employee participation:[13]

Period in Which Plan Became Effective	Contributory Plans	Noncontributory Plans
Before 1930	37	68
1930—1939	425	92
January 1, 1940—September 1, 1942	526	317
September 2, 1942—December 31, 1944	1,101	3,107
1945 and 1946	439	750
Total	2,528	4,334

These figures show clearly that of the pension plans still operating in 1946, those established before 1930 were predominantly noncontributory and those established during the next decade were predominantly contributory, that during the early 1940's, especially beginning with 1942, the trend was definitely back to noncontributory plans and that this tendency was not so prominent in 1945 and 1946.

Even a cursory examination of such data leads one to wonder why the rapid growth, why the sudden interest of employers to provide retirement benefits, to the extent of allocating as much as 17 per cent of compensation

[13] It should be added that the number of noncontributory plans is an estimate; the government statistics did not separate pension plans from profit-sharing plans with respect to employee participation but added the note, "It is reasonable to assume that very few profit-sharing plans provide for employee contributions, so that practically all the plans providing for employee contributions are pension plans."

to this purpose. The record may well provoke questions as to whether this is a stable development, whether it applies to a wide cross-section of industry, whether new plans will continue to be formed, whether the present ones will continue or whether this is merely a mushroom growth. Possibly employers have been "sold" on the value of old age benefits through the operation of the Old Age and Survivors Insurance of the Social Security Act, or there may be a combination of other causes that is suddenly leading employers to be so magnanimous and thoughtful of their employees. These questions will be postponed until after a review of the development of certain tax laws and rulings that may have some bearing on the answers.

Of the funded industrial retirement plans now operating in the United States—estimated as in the neighborhood of 7,500 in number—a large majority were created within the last five years and perhaps 95 per cent of them were established within the last ten years. A very substantial part of the contributions made to these plans in recent years—in some cases more than 80 per cent—would have gone to the federal government in the form of income or excess profits taxes had the plans not existed, unless the companies had found some other way of classifying these funds as necessary expenses. Detailed requirements of law and United States Treasury Department rulings must be met to make these tax advantages available with respect to employer contributions to pension plans.

These facts alone make one curious as to the influence federal taxation is having on industrial retirement plans. Would many of the plans be in existence were it not for this peculiar situation with respect to taxes and tax exemptions? Are the provisions of the plans colored by the requirements that must be met to obtain tax exemption? If this is the case, have these federal rules made retirement plans more or less valuable to employers, or employees, or both, than they would otherwise have been? To find answers to questions of this sort is the purpose of this study.

II. EVOLUTION AND MAIN PRINCIPLES OF RELEVANT TAX LEGISLATION

This section summarizes the development of the significant legislation governing the taxation of pensions and funds set aside to pay them, which is traced in some detail in the appendix. Then follows a discussion of the present law, with attention centered on its objectives and the extent to which these have been achieved. Another purpose is to consider whether in any further revision the patch-work procedure of the past should be continued or whether some different approach would be more effective.

Summary of Tax Developments

PRIOR TO 1942

When the first federal income tax law was enacted in 1913, there was relatively little interest in this country in plans for deferred employee benefits. However, some pensions were being paid, usually directly from employer funds, and decisions were made early that pension payments could be deducted as necessary expenses of an employer in computing net income for tax purposes.

As interest in deferred benefit plans grew, a general attitude as to income taxation gradually developed, evidenced partly by Treasury decisions and rulings and partly by federal statutes, which may be summarized as follows:

1. Employee trusts were not taxed with respect to their incomes,

2. Employer contributions to benefit funds were not taxed as income to the employer if beyond his control and recall,

3. Employee contributions were not deductible from the employee's income,

4. A pension was income to the extent it exceeded the pensioner's contribution toward its provision.

This status rested on subsections 22(b)(2), 23(a) and 23(p) and Section 165 of the Internal Revenue Code and the regulations and rulings that followed. While these sections and regulations were extensively revised in 1942, the four principles mentioned above persisted. Most of the 1942 changes had as their objective limiting the application of these four points to bona fide employee benefit plans.

1942 AMENDMENTS

The central tax question in connection with employee deferred benefit plans is under what conditions an employer may deduct his contributions to such a plan in calculating taxable income. The 1942 amendments of Section 165 converted it from a nominal to a formidable standard to be met if such deductions are to be allowed. This was accomplished by requiring that

1. The plan be for the exclusive benefit of employees and their beneficiaries, whereas formerly it was satisfactory that the plan be for the exclusive benefit of some employees,

2. The plan should not discriminate in favor of officers, shareholders, supervisors or highly paid employees through (a) the classes benefited, (b) the size of contributions, or (c) the benefits provided.

Aside from meeting the requirements of Section 165, the degree to which employer contributions are deductible is determined under the amended act by subsection 23(p). No previous act was definite and explicit on this point. This subsection allows as deductions (1) whatever level contributions or level percentage of salaries may be necessary, under regulations prescribed by the Commissioner of Internal Revenue, to provide all unfunded costs of the plan, or (2) under similar regulations, amounts necessary to cover "normal" costs and 10 per cent of the initial cost of past service or other supplementary credits. The section undertakes parallel handling of pension trusts, annuity plans and stock bonus and profit-sharing trusts.

Application of Subsection 23(a)

DEDUCTIBILITY OF EMPLOYER CONTRIBUTIONS

The 1942 Revenue Act was the first to state directly (1) that employer contributions to deferred benefit plans shall not be deductible under subsection 23(a), but (2) that to a specified extent they shall be deductible under subsection 23(p) (if they would have been deductible under subsection 23(a), had not the above stated provision removed them from consideration there).

This can be interpreted as saying that to be deductible employer contributions must fall within a deductible class of business expense under subsection 23(a) and then will be allowable only to the extent provided in subsection 23(p). It thus appears that subsection 23(p) is a limitation on deductibility of expenses of a class allowable under subsection 23(a).

The applicable clause in subsection 23(a) seems to be the first one which allows as deductions from gross income in obtaining taxable income "all the ordinary and necessary 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. . . ." Thus it seems that, in allowing employer contributions to deferred benefit plans as deductions in calculating the employer's net income, these contributions are classed as "ordinary and necessary expenses." This wording, though it has gone unchallenged for years, is open to question.

To quibble over the meaning of words merely for the sake of discussion is, of course, indefensible. But we seek here a basis for taxation or tax exemption in connection with employee benefit plans which will withstand analysis and will not merely assume that such plans fall roughly into a category which probably was established with no anticipation of their existence. Perhaps the latter was the natural thing to do when these plans were of practically no importance taxwise, but the fact that equities of substantial value are involved today needs no argument.

It appears almost obvious that employer contributions to pension plans are neither ordinary nor necessary expenses. The dictionary indicates that close synonyms of "ordinary" are "usual" and "normal." As antonyms it gives "unusual" and "extraordinary." Certainly, no one can deny that today there are far more employers who make no contributions to private benefit funds than there are who do. Such contributions are unusual rather than usual. And to say that they are "necessary" is an obvious distortion of the meaning of the word; if they were necessary, an employer could not operate his business without making them. No doubt the same criticism could be made of the classification of many other expenses that are deductible in calculating net income. So long as the tax collector is liberal in his interpretation of "ordinary and necessary," the taxpayer is not likely to object, but certainly the tax collector places himself in a poor position to insist that a particular expense is not allowable when the law continues complacently for some thirty years to use a descriptive term that so obviously is of no assistance in separating the sheep from the goats. Employer contributions to bona fide deferred benefit plans should be deductible as legitimate business expenses, but there is nothing to gain in clear thinking or fair treatment by routing them through a false classification as ordinary and necessary expenses.

The final expression in the first clause of subsection 23(a), "including a reasonable allowance for salaries or other compensation for personal services actually rendered," seems to be the basis for the Internal Revenue Bureau's rulings and regulations to the effect that employer contributions to deferred benefit plans are compensation.[1] Why is the bureau interested

[1] Section 29.23(p)-1 of Regulations 111 reads in part as follows: "A contribution under a plan that is set up for the exclusive benefit of employees as such, and thus represents an item of expense, is of the nature of compensation for personal services rendered by the employees covered by the plan." Article 23(a)-6 of Regulations 101 applying to the 1938 Revenue Act reads in part as follows: "*Compensation For Personal Services*–Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services."

in whether employer contributions are compensation or some other kind of "ordinary and necessary expenses?" And why did the drafters of the 1942 amendments use the extremely awkward language in subsection 23(p): "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, . . ." when they could have included a simple excepting clause in subsection 23(a) with reference to such contributions and then written subsection 23(p) so that it would stand alone? The answer to both these questions is that by insisting that employer contributions are compensation or in the nature of compensation and retaining dependence on subsection 23(a) for exemption, the Treasury could maintain that compensation, including allowable employer contributions, should be limited to a "reasonable" amount. There is no other provision of the law that defends this interpretation. If subsection 23(p) had been explicitly phrased to limit allowable contributions so that total compensation, including them, should be within a reasonable allowance, this clause would probably have met the same congressional opposition that similar efforts met earlier, attention to which has been called by Dean Griswold of the Harvard Law School, as follows:

> Congress has always resisted any effort to put a fixed limit on salary payments. In 1933 the Sub-Committee of the House Committee on Ways and Means reported that it had considered "the advisability of limiting the amount of the deduction allowed to a corporation on account of salary or other compensation received by an officer." But no recommendation was made, because, "if lower officers' salaries were actually paid, a loss of revenue would result." Preliminary Report of Sub-Committee of Committee on Ways and Means, 73rd Con. 2d Sess. (1933) 11; . . . .[2]

The point of view consistently developed in Treasury regulations and decisions of the Tax Court and judicial courts is that allowable employer contributions to benefit plans must qualify as compensation. In 1946 a taxpayer suggested that certain contributions made in 1940 and 1941 to a benefit trust should be deductible as ordinary and necessary expenses even if they were not considuered to be compensation. But the Tax Court disposed of this suggestion as follows:

> This brings us to a consideration of petitioner's further contention that the disbursements are deductible as ordinary and necessary business expenses in that they constitute a cost of maintaining an incentive plan or program.
>
> We have already decided that these payments were not "compensation paid." Subsection 23(a) deals specifically with "com-

[2] "The Deduction of a 'Reasonable Allowance for Salaries'," *Harvard Law Review*, May, 1943, p. 1000, footnote 14.

> pensation paid." It describes particularly the payments of compensation for services which are allowable for deductions. Such payments are not allowable unless they fall within those specifications. Under the doctrine of *"inclusio unius est exclusio alterius"* we think the section denies the deduction of such payments for services, regardless of their designation, since they fall outside the field of allowable compensation deductions.[8]

It is natural enough to think of employer contributions as being similar to compensation. Certainly they are made because the employer-employee relationship exists and in some way or other they are usually related in amount to the compensation of individuals or groups. But there are some fundamental difficulties here that seem not to be frankly faced. I think of my compensation for services actually rendered as something that belongs to me. It is not satisfactory to me that my compensation for service that has been completed shall be made to depend upon whether or not I remain with the same employer for any particular further period. There is a very troublesome incongruity to my mind in the concept that compensation for services I have already rendered is neither available to me now nor of such a nature that I have any assurance that it ever will be available to me.

Yet the fact is that far more often than not this element of compensation, called employer contributions, fails to vest in particular employees. Of the plans that had been approved by the Internal Revenue Bureau through August 31, 1946, 15.9 per cent provided immediate full vesting and 72.9 per cent provided limited vesting. But the 11.2 per cent of plans that provided no vesting accounted for more than half of all employees covered by all plans, and only 5.3 per cent of all employees were in plans providing immediate full vesting. The striking fact that prevents substantial actual vesting is that of the 43.9 per cent of all employees covered by the plans that provide vesting at some time prior to retirement, but not immediately, a very substantial proportion will withdraw from service before completing the conditions required for vesting under their particular plans.

Attention should not be called to this incongruity without immediately adding that no criticism is intended of any of the parties concerned. For many years industrial employers were frank in their contention that their contributions toward pensions were not intended as compensation. They were rather for the purpose of meeting definite problems that grow out of employer-employee relationships. Workers will grow old and public sentiment dictates that they shall not be thrown on the scrap heap without some source of income. Also a regular scheme of retirement facilitates promotions, the prospect of which encourages continuity of employment. Hence, quite aside from compensation for services, the better employers want to be

[8] Lincoln Electric Company, Petitioner, v. Commissioner of Internal Revenue, Respondent, 6 Tax Court 37.

ready to pension workers who grow old in their service. Looking at the matter in the most cold-blooded way, quite regardless of the adequacy of compensation paid currently as services are rendered, the effects of aging are such that the time comes when an employer can afford to pension an employee to keep him away from the plant—recognizing, of course, that public sentiment prevents dismissal. Fortunately, the proportion of employers is decreasing who are determined they will not contribute toward an old age benefit for employees who withdraw from their service before reaching retirement age.

Another thought that may be helpful in this analysis is that the label for employer contributions may be subjective instead of objective; the employer looks upon these contributions as a means of meeting a troublesome business problem in human relations. The employee, on the other hand, in so far as he has a serious expectation of return from these contributions, will certainly look upon them as returns for services. They would not be made if the service were not rendered; they meet an employee's need, as received after he becomes a pensioner, just as cash compensation enables the worker to meet current needs while he is employed. There is no reason why employer and employee should look upon these contributions in the same manner. Under the circumstances, it seems at least of doubtful value for the Treasury Department and the courts to be arbitrary in throwing these contributions into an artificial classification, if this may not be necessary and may tend to crystallize thought in situations that call for fluidity of thought.

As to the point of view of the Treasury Department, perhaps recognizing the incongruity of nonvested "compensation," a very serious effort was made in the suggested 1942 legislation to require vesting of pension expectations as a condition for deductibility of employer contributions. This would have removed much of the incongruity in the line of argument used for taxes and tax exemption, but it was a political impossibility, at least without far more educational work and well developed transitional provisions to prevent immediate hardship. Employer threats to discontinue nonvested plans brought to Congress an avalanche of protests from older workers who saw their pension prospects endangered. The country was not ready for such a change and time had not been available to work out the details to make it practical. Industrial employers as a group have never favored this improvement, perhaps because their interest is limited largely to those workers whom they expect to remain with them until retirement. To bring conviction that this is a short-sighted point of view would have taken far more educational effort than was possible in the rush of the 1942 legislation.

SIGNIFICANCE OF THE "REASONABLE ALLOWANCE" PHRASE

We repeat the clause of subsection 23(a) which has proved so important with respect to employer contributions; in computing taxable income for a business, there may be deducted "all the ordinary and necessary 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; . . . ."

According to K. Raymond Clark, "It is anticipated that most of the questions arising as to deductibility of contributions to employees' trusts will pertain to this requirement of reasonableness."[4] Examination of a large number of Tax Court cases and resulting appeals to judicial courts shows this to be at least a major cause of controversy. The clause quoted above is almost invariably the section of the law to be interpreted when reasonableness is involved. Then it seems that, uniformly, counsel for both sides and the parties who must make decisions take these words to mean that (1) employer contributions fall in the category of salary or other compensation, and (2) employer contributions together with other compensation must, to be deductible, fall within a "reasonable allowance." This uniformity of thought pattern can scarcely be overemphasized in the light of a bit of history recently uncovered by Dean Griswold.

Griswold finds that when an excess profits tax was levied at the time of the first World War, many partnerships, individual proprietorships and closely held corporations had been paying key men only nominal salaries, or none at all.[5] The excess profits tax law immediately worked a hardship for such organizations and the Treasury issued regulations for their relief, permitting them to deduct a reasonable amount for officers' salaries in computing the excess profits tax. Article 39 of Regulations 41 issued under the War Revenue Act of October 3, 1917, states,

> *Deduction allowed for salary to himself.*—An individual carrying on a trade or business having an invested capital may in computing the net income of the trade or business for purposes of the excess profits tax deduct a reasonable amount designated by him as salary or compensation for personal service actually rendered by him in the conduct of such trade or business. . . .

Griswold states that the Treasury sought statutory authority in place of this regulation and that the phrase "including a reasonable allowance for salaries or other compensation for services actually rendered" was incorporated in the House draft of Section 234(a)(1) of the Revenue Act of 1918; that, since the phrase was intended merely to do justice to an aggrieved group, there was no controversy about it and it was not even mentioned in committee reports on the bill which became law February 24, 1919. Article 32 of the same regulations provides similar relief in case of partnerships.

[4] K. R. Clark, *Profit Sharing and Pension Plans*, New York: Commerce Clearing House, 1946, p. 189.

[5] "New Light on 'A Reasonable Allowance for Salaries'," *Harvard Law Review*, December, 1945, p. 287.

As to closely held corporations, a 1918 Treasury publication entitled *Excess Profits Primer* contains as item 51 the following:

> 51. A corporation in which most of the stock is owned by officers has in the past voted to its officers only nominal salaries as drawing accounts. In computing net income for purposes of the excess-profits tax may the corporation deduct as items of expense amounts which would constitute reasonable compensation for the services actually rendered by its officers?
>
> Yes, if a satisfactory explanation is given. For any period prior to March 1, 1918, reasonable salaries for services actually rendered may be deducted, even though the full amounts had not been formally voted as salaries by the corporation.

In presenting this history, Griswold continues:

> Thus it now appears that the purpose of the phrase in question was to enlarge the deductions allowed by the general language, by allowing a deduction for amounts which had not actually been paid, and that there is no foundation in the statute for its use as a means of restricting the deduction of amounts which had actually been paid. . . . With this new light on the background of the provision, it is apparent that it has no bearing on the deduction of salary payments actually made, and furnishes no proper basis for the disallowance of any deduction. . . .
>
> Thus it appears that there is in truth no statutory foundation for the power which the Treasury in more recent years has assumed to supervise salary payments through the disallowance of deductions. If such a power is to be exercised, it should rest on clear statutory authority, and not on Treasury practice or misconstruction of the statute, no matter how long continued. . . .[6]

Griswold gives credit to another for unearthing the basic facts as follows: "The basic part of this material apparently first came to light in a brief filed by J. Marvin Hayes, Esq., of Washington, D. C., in a case which was thereafter settled so that no decision on the question was required."[7]

Griswold points out that this history of how the reasonable allowance phrase came into Subsection 23(a)—then Subsection 234(a)(1)—clears up and makes meaningful certain words and phrases that were formerly inexplicable. The initial word "including" was out of place in introducing a restrictive phrase. It is directly in place, however, if the phrase was to enlarge the range of applicable deductions by including a reasonable allowance for something that had never been paid as salary but was in recognition of services that had actually been rendered. On this point Griswold's comments read in part: "There is first the word 'including' which has never made sense as the introduction to a restrictive phrase. Then there are the

[6] "New Light on 'A Reasonable Allowance for Salaries'," *Harvard Law Review*, December, 1945, p. 290.

[7] *Ibid*, p. 287, footnote 3.

words 'reasonable allowance' for services 'actually rendered.' These have never quite fitted the Treasury's recent construction of the phrase as a limiting provision."[8]

All these difficulties disappear if the purpose was to tell businessmen that, in calculating income and excess profits taxes for their businesses, they might include under the heading salary or compensation a "reasonable allowance" for services "actually rendered" by or for them but for which compensation had not actually been paid.

From the point of view of logic and the ordinary meaning of words, an including phrase is the proper vehicle for forestalling the possible omission of, or failure to consider, an item that rightfully should be covered. If the purpose was to restrict, a different approach would have been appropriate. If the intent was to limit the part to be deductible as compensation of payments actually made as such even though they might be classed as ordinary and necessary expenses, a suitable clause to add might have been "except that only a reasonable amount may be included for salaries or other compensation and this must be in recognition of personal services actually rendered." The word "except," or its equivalent, is essential because this statement of deductible items begins with "all the ordinary and necessary expenses paid or incurred" and the whole of salaries and other compensation would come in this classification if there were no clause to except them either in whole or in part. To undertake to do this with an "including" clause is futile, especially when the statement starts with "all ordinary and necessary expenses." "All except" has meaning if the purpose is to limit, but to use "including" as an expression for limiting the "all" introduces a conflict of ideas.

If further evidence is of interest that the "allowance" for salary or other compensation originally had reference to cases in which less than the allowance has actually been paid, it may be noted that in other parts of Section 23 the word "allowance" is used when an actual dollar outlay has not been made. A "reasonable allowance" is deductible for exhaustion, wear and tear, and obsolescence. No part of the section introduces an allowance to replace an actual outlay.

A remarkable instance of the misinterpretation of this "reasonable allowance" phrase appears in the course of a Tax Court opinion as follows: "Undoubtedly, as the petitioner apparently concedes, the word 'paid' used in the first clause of subsection 23(a), *supra,* in connection with 'expenses' in which 'salaries or other compensation' are later included, must be treated as applying also to 'salaries or other compensation'."[9] While the clause is

[8] "New Light on 'A Reasonable Allowance for Salaries'," *Harvard Law Review,* December, 1945, p. 290.

[9] Lincoln Electric Company, Petitioner, v. Commissioner of Internal Revenue, Respondent, 6 Tax Court 37.

about ordinary and necessary expenses paid or incurred, the explanation here given of the history of the origin of the phrase "including a reasonable allowance for salaries or other compensation for personal services actually rendered" seems to establish that the opinion quoted above is entirely wrong in the conclusion that the added phrase has to do with salaries or other compensation actually paid; the phrase was introduced to deal with situations in which services had been rendered but adequate compensation had not been paid.

EFFECT OF OMITTING THE "REASONABLE ALLOWANCE" PHRASE

Unfortunate though it is that this "including" phrase of subsection 23(a) has been misunderstood for so many years—apparently by all who have had to do with controversies in which it is involved—the part of wisdom now would seem to be to face the facts of its origin and to reconstruct either the law or the taxing policy accordingly.

If it is congressional policy to limit amounts that are deductible as compensation when calculating income tax, that policy had better be stated in language so clear that it cannot lead to argument. Congressional history of the last fifteen years indicates that no such declaration of policy is likely. It may be well to consider how much or how little the absence of the reasonable allowance phrase would influence industrial pension plans. While decisions might have been different in some instances in which very substantial sums were involved, it may be that, from the standpoint of either the amount of federal tax revenue or the line of development of industrial pensions, the effect might prove to be relatively minor.

In the most flagrant cases of tax avoidance the Commissioner of Internal Revenue would probably be supported in a contention that exorbitant amounts are not ordinary and necessary expenses even if called salary or compensation. His argument might take the form that parts of such sums are not bona fide compensation and this would introduce a judgment as to reasonable compensation with no need for a phrase like the one discussed. Actually this occurred before the 1918 amendment and, since then, has been exactly the line of reasoning in some cases that have resulted in disallowance of part of so-called compensation as unreasonable.

Without the phrase discussed, the clause of interest in subsection 23(a) would read "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In keeping with the policy adopted in the 1942 amendment to cover tax issues of employee benefit plans in subsection 23(p) and Section 165, there could then be added to the above quoted clause of subsection 23(a) the following exception: "except that contributions to or under a stock bonus, pension, profit-sharing or annuity plan, or a plan deferring receipt of compensation, shall not be deductible under this subsection." Then the present awkward wording of the initial sentence of subsection 23(p) could be simplified to read

> (1) *General Rule*—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 for deferring the receipt of such compensation, such contributions or compensation shall be deductible, if at all, under this subsection, but only to the following extent: . . . .

This simplification would be possible because the present tie-in to subsection 23(a) apparently is for the purpose of making use of a limitation on size of contributions by application of a phrase that has furnished this limitation through misinterpretation. Unless Congress sees fit to introduce a provision specifically to limit compensation or contributions to pension plans, it therefore seems desirable to eliminate dependence on subsection 23(a), because it contributes nothing and merely interferes with the objective of centralizing the taxing provisions that bear on various types of benefit plans.

If the "reasonable allowance" phrase were omitted, there would no longer be anything to gain by classifying employer contributions as compensation or in the nature of compensation unless vesting of pension credits could be required. This is important at present because a legal limitation on salaries or compensation is established by the "reasonable allowance" phrase and its misinterpretation and therefore a position is appropriate as to whether or not employer contributions should come under the stated limitation. If the limitation disappears, it would no longer be significant to determine whether employer contributions were compensation or some other kind of ordinary and necessary expenses.

Function of Section 165

While Section 165 originally had the narrow purpose of exempting from taxation employee benefit trusts created for the exclusive benefit of some or all employees, it was expanded in scope when compliance with the section became a prerequisite for tax exemption of funds placed in a pension trust to support past service benefits. In 1942 when Congress went seriously into legislation regarding the tax treatment of employee benefit funding, Section 165 was amended to make it a genuine testing instrument for good plans. And by amendment of subsection 23(p) the controls of Section 165 were extended to all classes of employee deferred benefit plans. The novel 1942 hurdle introduced in Section 165 consists of tests devised to require, for favorable tax treatment, that a deferred employee benefit plan shall "benefit" (1) at least a specified proportion of full-time, presumably permanent employees, the least possible proportion being 56 per cent, or (2) a group of employees found by the Commissioner of Internal Revenue not to be discriminatory in favor of officers, shareholders, supervisors or highly paid employees. Furthermore, it requires that no discrimination of the kind mentioned above be introduced by the nature of either contributions made to the plan or benefits provided by it.

To implement this prohibitation of discrimination through contributions or benefits, extensive regulations provide that the benefit formula shall not favor higher as compared with lower paid employees when total prospective benefits, including old age and survivors' insurance benefits for man and wife in addition to those provided by employer contributions under the private plan, are considered as a percentage of compensation.

Function of Subsection 23 (p)

As already stated, the 1942 amendments centralized in subsection 23(p) nearly all provisions with reference to deductions allowable to an employer in connection with contributions to employee deferred benefit plans. The new version recognizes many complications and explicitly places certain authority and discretion in the hands of the Commissioner of Internal Revenue instead of trying to determine all questions by statute. There is of course a wide difference of opinion as to whether or not this is advisable; perhaps it is essential unless the legislation is greatly simplified. The amended subsection makes the law more explicit than before and also distinctly more restrictive. It clears up definitely that, to be deductible, employer contributions must qualify as ordinary and necessary expenses under subsection 23(a). Heretofore, the law had contained no restriction on the deductibility of ordinary and necessary expenses, but subsection 23(p) goes into considerable detail to spell out the extent to which employer contributions are deductible even after they qualify as ordinary and necessary expenses.

From the standpoint of the administrator, the law prior to 1942 left much to be desired in a field that was coming to involve questions of ownership of large sums of money. Neither Internal Revenue officers nor taxpayers were satisfied to have the decision as to whether contributions toward "pension liabilities accruing during the year" were deductible under subsection 23(a) determined according to the opinion of a revenue officer. Nor was it satisfactory that 10 per cent of "reasonable amounts" paid to trust funds in addition to contributions to cover a pension liability accruing during the year should be deductible.

The indefiniteness of such expressions as "past service credit" and the "pension liability accruing during the year" which appeared in the earlier law had made it difficult to defend the arbitrary classification of contributions as being for current or other credits. A recognition of these defects on the part of the legislators is reflected by the inclusion in the amended subsection 23(p) of a level percentage or level amount method of funding the liability for all credits as an alternative to separate allowances for "normal costs" and all other costs. The amendment has the practical virtues of being far more specific than the former subsection and evidences systematic analysis of major classes of situations that had arisen.

Regarding the deduction of large contributions for other than normal costs, it is of interest to note the difference in method under the old and new legislation. Prior to 1942 if such a contribution made in a particular year was "reasonable," 10 per cent of it was deductible for each of ten successive years. Under the amendment, the amount deductible in a particular year is 10 per cent of the cost of past service benefits or other special annuities at the time they were included in the plan. The whole of a contribution of a particular year up to this limiting amount would be deductible in that year and any excess of a contribution over this limit would be deductible in any succeeding year, except that the total allowance for a single year is not to exceed the 10 per cent limitation.

Effectiveness of Antidiscrimination Requirement

Subsections 165(a) and 23(p) undertake to limit tax advantages to plans that avoid discrimination in favor of officers, shareholders, supervisors or highly paid employees, in determining coverage, contributions or benefits. The regulations formulated to carry out this new idea have developed the concept of integration with social security benefits. It may be worth while to consider the success that can be expected from the law and regulations in this regard.

DISCRIMINATION INVOLVED IN FORFEITURE

So long as forfeiture of pension credits is practiced, it will be difficult for a plan to avoid discrimination against the lower paid employees. If employees are classified according to length of service, almost invariably the short-service employees are at once the lower paid and those having the highest withdrawal rates. Hence, if pension credits are always forfeited upon withdrawal, or if they are forfeited upon withdrawal before completion of a specified period of service or pension plan coverage, the lower paid employees are bound to profit less from the existence of the retirement plan than will the highly paid or the supervisors, officers or employee shareholders.

An employer may establish a plan covering all employees which includes no preliminary service requirement and still rest assured that in fact he will favor officers, supervisors and the higher paid employees if the plan contains a provision for vesting of pension credits upon withdrawal only after a specified period of service, however short. Usually the length of this period of service is such that a majority of employees in the lower paid class will have withdrawn from service before completing it, while a far larger proportion of officers, supervisors and highly paid employees will either remain in service until retirement or will, before withdrawal, complete more than the period of service required for vesting of benefits.

This situation is well understood by industrial employers and by their pension counselors. In fact, they recognize that in years of high corporation income tax rates it may be definitely advantageous to set aside large sums on behalf of employees who will probably withdraw after relatively short service. Pension credits being forfeitable, at least with respect to those who withdraw early, these withdrawals will release large sums in later years to credit against contributions then due, and the hope is that the tax rate will then be lower. Jonathan G. Sharp, a consulting actuary, wrote in 1944:

> Some companies feel that during this period when many workers are necessarily temporary it is unwise to start a plan. They do not realize that in the accumulation of a fund, the temporary group helps to pay off liabilities quickly, *provided definite annuity commitments are not entered into for temporary workers*. The saving in this case may be hundreds of thousands of dollars to an average-sized company in reduction of its pension cost.[10]

To minimize this gamble in the hope of tax avoidance, the Treasury regulations permit, in calculating the annual contribution to a pension plan, discounting in recognition of withdrawals from service; if no account is taken of probable withdrawals in making this calculation, contributions on behalf of employees with less than five years' service are sometimes disallowed. The interest of employers in avoiding both discounts for withdrawal and contributions that will not be allowed as business expenses in calculating their income taxes is indicated by the fact that large numbers of recently established pension plans limit coverage to those who have completed five years of service.

Thus, there is the peculiar phenomenon of the Internal Revenue Bureau encouraging discrimination against the lower paid employees by a procedure that has in many plans been responsible for excluding the lowest paid—those with less than five years' service—from any coverage under the plan. The purpose in doing this is to keep to a minimum the employer contributions that are tax exempt.

INTEGRATION AND DISCRIMINATION

Interpreting the antidiscrimination provisions of Section 165, Treasury rulings have been developed to discourage more favorable benefits for employees with annual compensation higher than the Social Security limit of $3,000 or the railroad retirement plan limit of $3,600 than for lower paid employees. These rulings get into troublesome details, and some companies have cut the Gordian knot by avoiding in their pension plans any distinction

[10] J. G. Sharp, "Safeguarding Pension Plans," *Journal of Commerce* (New York), May 15, 1944. (Emphasis in text supplied by author.)

based on salary in determining contributions or benefits or else by making any such distinction less favorable percentage-wise to highly paid employees. But it must be remembered that under most plans a large majority of all employees who withdraw from service will completely or partially forfeit their pension credits. Hence, only in form do the requirements of "integration" and the plans that are more liberal to the lower paid than required by regulations avoid discrimination in favor of officers, supervisors and highly paid employees.

Subsections 165(a)(3)(A) and (B) require that, to qualify, a trust must be part of a plan designed to benefit employees in numbers or classes so chosen as to avoid discrimination. The word "benefit" could be crucial. Doubtless the interpretation is that the plan shall benefit the required number or classes of employees if they continue in service until retirement. But everyone knows that most of them will not do so and that a much larger proportion of those who are not supposed to be favored by the plan will remain to receive its benefits.

The employer in almost every case may rest assured that the plan will in the main furnish substantial benefits with respect to those who retire from the classes that mean most in the development of the business and that satisfactory benefits will be provided for the small proportion of lower paid employees who remain in service until retirement. He will also know that probably little cost will be involved for those who withdraw from service and that contributions on their behalf, if liberally calculated in years of high tax rates or high company earnings, can be expected to be very productive, because of tax exemptions when high tax rates would be involved, in minimizing the cost of the benefits he desires to provide. Turnover is high among employees below the rank of supervisor and especially high among unskilled and other groups of lower paid employees, and there is little evidence that any change in this situation is to be expected soon. It is obvious that, so long as pension credits are forfeitable upon withdrawal from service, pension plans will be of little value to the masses of lower paid workers. Large numbers of these employees will work for many different employers during their active years and yet be with no one of them long enough to acquire the right to substantial company benefits on retirement; a small proportion of them will graduate into the supervisor class or into skilled classes with higher pay and perhaps longer tenure; a few will become officers with still better prospect of remaining with the same employer long enough to make a pension plan really count. While almost any company with a pension plan can show that it retires more rank-and-file workers than it does officers or supervisors, the proportion of pensioners is generally far higher among officers and supervisors than among others.

MANAGEMENT OBJECTIVES

These comments are in no sense a criticism of the employer attitude. A corporation has many reasons to be more solicitous about the key men in the organization than the rank and file of employees who come and go and, generally speaking, develop little loyalty for the particular organization. Competition is keen for the services of men with qualifications to be supervisors and officers. These men are close to top management and, at the upper margin, merge into top management. Not less important, it is vital to good management that the organization be relieved of the services of persons of this group—including top management itself—as senescence approaches.

Hence, from the standpoint of a management that is not industrial relations minded, it may be entirely sound, in establishing a retirement plan, to center attention on employees of just the groups with respect to which the act prohibits discrimination if care is taken that this is not too obvious. Furthermore, the tendency will be strong to find ways that are within the law to favor employees of these groups. And the interesting fact is that this objective is not at all difficult of accomplishment so long as forfeitable pension credits are approved, because

1. The more valuable employees are least likely to withdraw from service,
2. Provisions for retirement benefits make more of an appeal to them than to others and thus help to reduce still more their withdrawal rate,
3. A forfeiture clause in the plan makes these men hesitate to withdraw when their pension credits become substantial.

As already pointed out, the present revenue act presents few problems for the employer who takes this point of view. The pension plan can be stated to call for nondiscriminatory contributions and to provide nondiscriminatory benefits, and the rules of coverage can be so arranged as to be approved by the Commissioner of Internal Revenue. But if vesting of pension credits calls for say ten or five years of service and attainment of age fifty or fifty-five, or if there is no vesting provision, the employer can rest assured that the plan will cost comparatively little except with respect to employees of groups in favor of whom he must not discriminate, and that, unless tax rates or earnings are increasing, contributions made on behalf of employees of other classes will reduce the cost of benefits to be paid employees of the favored group.

EMPLOYEE OBJECTIVES

Pension plans are coming to have a place in collective bargaining, but what may develop in this direction has not yet been thought through with much care. Unreasonably liberal suggestions have been made; often relations between benefits, conditions for their receipt and reasonableness of cost have not been worked out. Employers have publicized their retirement plans as a means of attracting applicants and in the hope of decreased labor turnover. Perhaps whatever influence has derived from these presentations has not resulted from careful analysis of plan details.

The aims of unions in this area are not yet clear, but if there is to be bargaining about specific features of pension plans in detail union officers must acquire a better understanding of the problems that attend the shaping of such plans than they have yet evidenced. They must take into account that many of their members work comparatively short periods for particular employers. Voluntary withdrawal rates are high and involuntary breaks in employment are frequent in normal times. The employee or his representative should never lose sight of these facts when estimating the value of pension plans as consideration for employment. So long as most pension plans retain the forfeiture provisions they now have, organized labor would be very shortsighted to place important bargaining value in them. That this is the case is evidenced by the tenacity with which many employers resist strengthening vesting clauses and the intensity of the resistance to the Treasury's 1942 recommendation that pension credits be nonforfeitable for tax exemption of employer contributions. Repeatedly the objection is presented that a broad nonforfeiture clause would be extremely costly. This is exactly the employee's argument for its use. In defending the present status, the employers are likely to deprecate the importance of withdrawals on the effectiveness of their plans, but the employees can well point out that whenever withdrawal rates cease to be of great importance, the cost of broader nonforfeiture provisions will be minor. After all, the final cost of a pension plan is largely the sum of benefits paid. Hence, to the extent a comprehensive nonforfeiture clause that avoids lump sum settlements would increase costs, pension credits at the rates established by the plan would be furnished which are not now furnished. Substantial service is now being rendered which is not doing its share toward providing benefits for the workers.

Despite the fact that the vesting provisions of so many plans are of little value to large numbers of the rank and file, lower paid workers, the trends of recent years in vesting provisions are definitely commendable. These provisions are far more liberal than they were some years ago and are of very definite value to employees who continue to be covered by a particular pension plan long enough for full vesting to apply. These provisions are particularly valuable because they usually offer only annuity benefits so that, if they operate, the pension prospect cannot be destroyed through the employee's desire for cash. It is to be hoped that the conditions for vesting may be further liberalized and that the option to take cash upon withdrawal may be eliminated in a growing proportion of plans.

WARNING OF NEED FOR REVISING TAX LEGISLATION

Congress had five years' warning of the need of better provision to minimize tax avoidance through the deferred benefit route. Pension trusts as a possible means of tax avoidance were considered briefly in 1937 by the Joint Committee on Tax Evasion and Avoidance. Several other items took the principal attention of the committee because clear evidence was available as to their importance. Pension trusts were only "suspect," and hence the committee was satisfied merely to place in its records a statement prepared by Honorable Charles T. Russell, Deputy Commissioner of Internal Revenue. This procedure was stated by the Under Secretary of the Treasury Roswell Magill, as follows:

> At the meeting yesterday we mentioned among other things that we hoped to present the subject of pension trusts. That section has been in the Revenue Act for a number of years; I think for some sixteen years. It apparently has not been made use of much, at least, for the purposes of tax savings, until recently, and even yet we have comparatively few cases on the subject. The Deputy Commissioner, Mr. Russell, has prepared a discussion of the provision and included an article or two which have been written by insurance men indicating the possibility that there may be some loopholes there which we had not thought of heretofore. Since there are a number of other matters to be presented, it occurred to me that possibly the most expeditious thing was simply to put this document into the record. There are no names or cases. It is simply a discussion of the subject with a view to possible improvement in the legislation.[11]

The following excerpts from Mr. Russell's statement, which is printed in full in the minutes of the hearings, give an idea of the evidence which he had at that time:

> The evidence at hand indicates that some closely held and closely controlled corporations are attempting to distribute profits in the guise of pensions. It is further indicated that some corporations are attempting to pass what really amounts to compensation or bonuses into pension trusts, thus postponing the taxation thereof until the period of their retirement, at which time it is expected their individual brackets will be much lower because they will not be receiving salaries. . . . In either of the cases mentioned it may well be that the corporation would have distributed the profits or paid the bonuses direct to the stockholder officials and key men were it not for the tax advantages realized by the use of the pension trust plan. . . . I do not believe abuse is widespread at this time, but the material which I will later submit for your consideration indicates that it may well become so. . . . But we are fearful that

[11] United States Congress—Joint Committee on Tax Evasion and Avoidance, *Hearings Before . . .*, Washington, 1937, (75th Congress, First Session) p. 290.

improper use of the provision is being stimulated by propaganda at a rapid rate.[12]

Mr. Russell quoted at length from *The National Underwriter* of April 23, 1937, and two excerpts from these quotations are given below:

> Pension trusts present an enormous opportunity to life insurance men and open up a field that is certainly as big as anything that has gone before, M. M. Goldstein, assistant manager, Clifford L. McMillen Agency, Northwestern Mutual Life, New York City, told New York City Chartered Life Underwriters and their guests at the April meeting. "In my opinion, this represents the largest single untapped field for service and sales in our business today," he declared. . . . As to the tax angle, the speaker said that when the normal federal corporation income tax, the New York franchise and the federal undistributed profit tax are taken into account. it works out that the employer is using 64-cent dollars when he contributes to a pension trust, rather than adding it to surplus.[13]

Mr. Russell's statement concluded with legislative recommendations, to which the committee gave no consideration. Briefly, these were that

1. There be better correlation between subsection 23(p), which then applied only to pension trusts, and Section 165 which applied to stock bonus, profit-sharing and pension trusts,
2. A maximum statutory restriction be considered on the amount of pension that could be deducted under subsection 23(p) and treated as exempt under Section 165 (this is not quite clear because apparently it was not then necessary to bring actual pension payments under Section 165 at all),
3. There be a definite statement of the number or percentage of employees that must be covered by a plan to make it a "reasonable" plan. On this last point, Mr. Russell's statement reads in part as follows:

> One of the phrases in the act deserving of special study is the expression "some or all" in Section 165. Literally this language would permit the benefits of Section 165, consisting of postponement and reduction of tax, in cases in which only a few top employees were participants in a plan. Some substitute phrase would seem desirable making it clear that a plan must be for the benefit of a reasonable number of employees.[14]

4. A provision be considered to prevent recapture of trust funds by the employer.

The only Russell recommendation that resulted in legislation prior to 1942 was the one about recapture. Amendment of Section 165 to require

[12] United States Congress—Joint Committee on Tax Evasion and Avoidance, *Hearings Before . . .*, *op. cit.*, p. 291.
[13] *Ibid.*, p. 292.
[14] *Ibid.*, p. 294.

that the trust be irrevocable was enacted in 1938 and became effective in January, 1940. The first and third of his recommendation as listed above appear in 1942 legislation, but the second, that a statutory limit be placed on pension payments to be deductible, has never been adopted.

Taxation Principles and Deferred Benefit Plans

Economists have for generations undertaken to state the concept of income from their several standpoints. Without doubt, legal opinions reflect conscientious efforts to apply these statements and to formulate lawyers' views. Legislators must meet stubborn, practical difficulties in applying sound ideas of income to their problem of levying taxes. Only the courts can keep legislative bodies on a sound theoretical basis and they can do this only if legislative abuse brings forth contests involving departures from sound theory. Even when these contests occur, the courts are too likely to lose sight of the fact that Congress has no constitutional power to define income or to tax as income anything that is not income.

When Irving and Herbert W. Fisher wrote *Constructive Income Taxation* in 1942, they asked outstanding students to state their concepts of taxable income. Among the responses, they quote from Erwin N. Griswold as follows:

> There are at least three elements in taxable income, which must be carefully considered, and often distinguished. These may be indicated by the words: (1) *what* is income? (2) *whose* income is it? and (3) *when* is it income? To a considerable extent these elements merge and blend, but they are, I believe, essential parts of any concept of taxable income.
>
> It seems to me quite accurate to say today that taxable income includes any items of receipt or increment or benefit that Congress chooses to make taxable, except that probably that part of the receipts from the sale of property equivalent to the cost of the property sold may not be taxed as income. And Congress has in fact said, and the Court has held, that virtually all of such receipts, increments, and benefits are taxable, except (1) gifts and their inheritances, (2) use income, and (3) unrealized capital gains. It seems to me not impossible that these three present exceptions may be put to some extent in the taxable class before present developments are over.[15]

Whenever economic income seems to appear, the tax collector's instinct is to tax it. Wages are expenses to the employer but they are income to the employee and the tax collector soon gets his share. But employer contributions to a deferred benefit plan are to him unorthodox. They are not income to anyone when contributed and result in taxation only when a beneficiary

[15] H. W. Fisher and Irving Fisher, *Constructive Income Taxation*, New York: Harper and Bros., 1942, p. 122.

begins to receive a corresponding benefit. Even income earned by these contributions is tax-free until benefits are paid.

In one particular, deferred benefit plans are orthodox—the tax collector has firm hold on employee contributions; they are taxed at once without too much scrutiny as to whether or not they are actually income. The debits and credits are kept straight by insisting that, when benefits are paid, everything received in excess of employee contributions shall be taxable income as received. Of course the rate of taxation may be low and much may be exempt because of the then low income bracket of the recipient.

Paragraphs that follow undertake to analyze these practices as to the incidence of taxation from the standpoint of income concepts.

EXEMPTION FROM TAXATION OF EMPLOYER CONTRIBUTIONS AND EMPLOYEE TRUSTS

Employer pension payments and contributions to deferred benefit plans approved under Section 165 are deductible by the employer to the extent recited in subsection 23(p) and become income to the employee only as he receives benefits under the plan. The general assumption behind this rule is that, at least so far as taxation is concerned, employer pension payments and contributions to employee benefit plans are in the nature of compensation. They are payments reaching individuals immediately or ultimately because of their employment or the employment of their relatives or those upon whom they have been dependent. Presumably the payments are not gifts but are made because of employment and with the thought that their payment will be of value to the employer's business.

It is helpful to apply Griswold's questions to employer contributions. Are they income? For the employer they constitute expenses and the plan will be approved only if they can never be recaptured. Whose income? When is it income? If unreasonable as contributions, they may be immediate compensation or dividends to chosen employees; as such they would be taxable at once. If they meet all the tests to make them bona fide under an approved plan, they are not income to anyone when contributed but will result in income to employees, years hence, in the form of benefit payments. To which employees? Under most plans no one knows at the time the contributions are made; this is one difficulty in interpreting them as income at that time. Another difficulty is that they are not available to any employee at that time and cannot be made available; no employee could make use of them, not even to pay taxes.

Hence we can say that employer contributions are deductible by the employer because they are legitimate business expenses if they meet the legal requirements to be bona fide, and they are not then taxable to the employees because under many plans they are not credited to anyone in particular and, even when they are, only a conditional right to something in the future is involved; income that an individual can control is not present. Here we have values in a peculiar state of suspension. Employer contributions support conditional promises, a calculable proportion of which will probably result in benefits, but no one now knows to whom, when, or to what extent. This is not the kind of a credit that furnishes a strong defense for taxation despite the fact that new economic value is the basis of the contributions that give rise to it.

Enactment in 1921 of subsection 219(f) to exempt employee trusts from income tax was presented as a congressional effort to encourage these trusts. Certainly the investments of an employee trust produce income and if this were taxed the distributee would receive less, hence this legislation made contributions to employee trusts more productive. Presumably the employee would pay less tax eventually if it were not for this legislation, partly because he would receive a smaller benefit if the trust were taxed and partly because he would not be taxed on the element of his receipts that represented income of the trust, since this would already have been taxed. This suggests that one reason for exempting trusts from taxation may have been to prevent the nuisance that would otherwise have been involved in avoiding double taxation. This nuisance is far from minor in a pension trust, because the equities of individuals in the trust involve a number of factors that complicate calculations.

In dealing with pension trusts, it is desirable that, in so far as possible, tax rules be such as to treat alike pension plans that use pension trusts and those that provide for purchase of deferred annuity contracts. If such contracts are purchased by employer contributions, the income from the premiums has not usually been taxed to the employer; calculation of benefits is based on the assumption that specified interest earnings will be added to reserves, and methods of taxing life insurance companies have usually tried to take this into account. It would be troublesome to tax explicitly either the employer or the employee for the earnings of the premiums. Parallel treatment requires that contributions to a trust fund should not be taxed to the fund and the present rule has this virtue. Benefits, whether produced by earnings of the trust fund or the annuity premiums, are taxable income to the recipient.

Another comparison of interest is between (1) establishing a pension trust from which to pay pensions, and (2) paying them out of general funds or a company reserve established for the purpose. This is hardly the place to list the advantages of the pension trust method as contrasted with company reserves; they are many and sound. But from the standpoint of actual dollar costs an advantage of the pension trust lies in freedom from taxation of its income. True, the employer is also freed from tax on payments made to the pension trust, which is not the case with payments set aside in a company reserve. But, if the rate of interest accumulation is the same in the company reserve and the pension trust, there is no financial advantage on this ground; the tax exemption on payments into the trust fund is exactly balanced by the tax exemption on pension payments from company funds made directly to the pensioner, if the same tax rate applies throughout.

It is well to look at the tax exemption of the income of benefit trusts from the standpoint of Griswold's three questions: (1) Is it income? Certainly the investment of trust funds will produce incomes in the most genuine meaning of the word. (2) Whose income? Surely not the employer's in any technical sense, because the trust must be for the exclusive benefit of the employees in order to qualify for tax exemption and must be irrevocable. And yet, if the employer plans to provide predetermined pensions to employees, the necessary contributions would be larger were it not for the tax exemption. An irrevocable trust, the corpus and income of which is to be distributed to employees, would seem to belong more nearly to employees than to the employer. But the interest of a particular employee in a pension trust is more likely than not to be unvested and, even if vested, its value is usually contingent upon continued service or longevity or both. Perhaps it is best to beg this question and merely say that the income belongs to the trust without trying to go further. Prior to 1921 the income of an employee trust was apparently taxed to the trust, the employer, or the employees, depending upon the wording of the trust. The 1921 rule had the practical virtue of avoiding any such decision as well as by-passing double taxation.

Griswold's third question, "when is it income?" would seem to call for the answer year by year or at each accounting period. Section 165 exempts the trust from taxation and also makes taxable to the employee, except as modified by the so-called 3 per cent rule, the excess of any benefit he receives over whatever contributions he may have paid. One rationalization of this procedure is that the principal and income of the trust are income to the employees as a group as these sums come to the trust, but the share of an individual is not knowable except as distribution is made. Payments to a distributee in excess of his contributions are income to him as received; so the simplest method of avoiding administrative difficulties and repeated taxation of the same item is to use the rule stated above.

BASIS FOR TAXING EMPLOYEE CONTRIBUTIONS WHEN MADE

One consistently applied income tax rule is that an employee's contributions to an employee benefit plan are not deductible by the employee in obtaining net income for tax purposes when contributions are made; they are deductible from benefit payments, subject to the 3 per cent rule. Some employee benefit plans make no provision for employee contributions; some permit employee contributions in expectation of increased benefits; some require the contributions if the employee is to participate in benefits but do not require participation in the plans; and some require contributions as a condition of employment for specified classes of employees. The tax rule regarding employee contributions is the same for all. The same rule applies to employee contributions to the United States Civil Service Retirement and Disability Fund and to employee taxes under the Railroad Retirement Act and for Old Age and Survivors' Insurance under the Social Security Act, all of which are required of eligible employees.

Differences in Nature of Employee Contributions: As a matter of convenience in tax administration, there are great advantages in having this one rule apply uniformly to employee contributions. But the rule justifies some thought, particularly when we distinguish between voluntary and compulsory participation. It is well again to ask the three Griswold questions. First, are employee contributions income? In practically all cases these contributions are deductions from compensation and compensation is not only income but, with most employees, it is almost the only source of income. What more is needed to show that an employee's contributions are part of his income?

But consider the following sets of circumstances:

A, with a salary of $200 a month, must contribute 3 per cent of salary to a retirement plan, this to be matched by the employer in providing a fully vested benefit.

B, with the same salary, may contribute 3 per cent of salary to a retirement plan, this to be matched by the employer, but he need not do so.

C, with a salary of $194 a month, contributes nothing to a retirement plan but his employer contributes $12 a month to provide a benefit for *C* whose rights in this benefit vest from the beginning.

Assume, for simplicity, that in all three cases the retirement equity is noncashable.

A and *B* alike report income of $200 a month while *C* reports an income of $194 a month. All three have take-home pay of $194 a month, assuming *B* contributes. When retirement benefits start, the whole of *C's* benefit will be taxable income from the start; with *A* and *B,* the contributions they have paid will be deductible from pension payments in calculating taxable income. The complication introduced by the 3 per cent rule will be ignored in the present comparison.

The status of *A* seems to be the same as that of *C* with the exception of tax treatment. *A* has the choice of accepting $194 a month with $12 a month dedicated to a pension or getting another job. So does *C*. Both *A* and *C* are taxed with respect to pension contributions, *A* to the extent of $6 a month while employed and the equivalent of $6 a month when pension payments begin, and *C* with the equivalent of $12 a month when pension payments begin. Presumably, *C* will be in a low income tax bracket when his tax begins. In making out his income tax returns, the employer takes credit for $206 a month deduction from gross income with respect to each employee, assuming *B* participates.

Going back to Griswold's first question, the contribution of *B* seems to qualify as income to *B* at the time the contribution is made; it was a part of his compensation and he could have used it for other purposes had he so desired. It was paid, or payable, to *B* and was at his command.

But how about *A*? His $6 a month contribution was neither paid nor payable to him; it was not at his command; he could not use it for any purpose. It either supported a pension prospect or *A* sought another job. It would seem not to be income constructively received.

When contributions are required, an employee's contribution to a benefit plan is no more a part of his income than is his employer's contribution. If an employee's required contribution is not allowable as a deduction from salary, then for tax purposes the employer's contribution should be added to salary income for both *A* and *C*. The employee has no more control over the existence of one than the other and no more ability to dispose of one than the other. They both function alike; neither is of any value to buy food or pay taxes.

The writer would answer the Griswold questions by saying that an employee's voluntary contribution is part of his income at the time the contribution is made; a compulsory employee contribution is not employee income at the time the contribution is made, but is reflected in employee income at the time of benefit receipt.

The words wages and salary are used quite loosely in common parlance, as is shown clearly by the question under discussion. In the examples given above we speak of *A's* salary as $200 a month, and that of *C* as $194 a month. The contracts of employment, written or oral, are quite closely parallel propositions. Each is to receive $194 a month to take home; for each, conditional equity is created with $12 a month, and neither of them has any command over this $12 or any part of it except through the contractual rights to benefits when stated conditions precedent have been met. Furthermore, *A* has the same kind of a right with respect to the $6 a month deducted from his "salary" as with respect to the $6 a month contributed by the employer; one is the same kind of compensation return for service as is the other.

Perhaps no harm is usually done by the loose use of the words salary and wages, but, upon examination, we should recognize that *A's* salary consists of two parts which are widely different in character. With $194 a month *A* can do as he wishes. It can be used to satisfy any wants or desires he may have, but not so with the other $6 a month. In fact he not only never receives this $6 a month; he has no contractual right to receive it. His agreement for employment would be more accurately stated if it called for (1) $194 a month in cash and (2) deferred annuity expectations with clearly specified characteristics including stated magnitudes. The employee understands that this annuity expectation is what can be purchased through a deferred annuity contract or what it is estimated can be provided under a pension trust with purchase money of $12 a month. But the fact of real importance is that *A* has no right to $200 a month or $206 a month, but only to $194 a month in cash and annuity expectations with closely definable characteristics.

This fact is disclosed very quickly if, after a deferred annuity contract is purchased from an insurance company in accordance with the plan, *A* requests return of either his $6 a month or the whole $12 a month purchase money. The insurance company will take the stand that all of the cash funds and investments it holds belong to it rightfully and that it has none of *A's* money. Its obligation to *A* is to carry out a contract that has been entered into, mainly, to make certain annuity payments to him when the conditions precedent for those payments have been met. The insurance company would be open to criticism if it took the point of view that its obligation to *A* was to return the contributions that had been made on his behalf. It is fundamental, whether in insurance or other affairs, that, if, in return for a consideration paid by *X*, *Y* undertakes specified obligations, the consideration belongs to *Y*; *X's* enforceable right is to have *Y* carry out the obligation he has undertaken.

In the earlier examples, *A* contracted to furnish his services in return not for $200 a month or $206 a month but rather in return for $194 a month and specified pension expectations, two elements of compensation quite different in nature. The additional annuity expectation element each month presumably has a value of $12. That $6 of this is called salary, and the other is not, merely reflects looseness in our use of the word "salary."

This point is emphasized because our income tax rules accept this nontechnical meaning of the word "salary" rather than recognizing the peculiarities of the elements of compensation involved. If the compensation to be taxed is the part that the employee has a possibility of controlling and using as he sees fit, then *A* and *C* should each be taxed on $194 a month. If they are to be taxed on the full outlay that the employer makes because of their services, the figure should be $206 a month in each case. It appears indefensible to tax *A* on part of his so-called salary that becomes annuity consideration but not on the employer's contribution when neither can possibly be received in cash, and to refrain from taxing *C* currently for any part of the pension expectations created for him.

Court Decisions: Little direct light is thrown on this question by court decisions. The case which on its face seems most directly applicable is that of Cecil W. Taylor v. Commissioner, 2 T.C. 267, in which Taylor contended that contributions required of him, as a federal employee, under the United States Civil Service Retirement and Disability Act did not constitute taxable income. The opinion of the court states that the petitioner's position could be supported if either (1) the benefits were illusory, or (2) "failure to receive the disputed payments [salary deductions] in cash eliminates them from the taxable income of a cash basis taxpayer."

In the industrial plans on which we seek light, it is granted at once that employee contributions create equities of genuine value to the employee. The whole question is whether or not compulsory contributions constitute income taxable (1) when salary deductions are made, as contrasted with (2) when benefits are received. There is no doubt about the existence of economic values; the question is Griswold's third, "when does it become income"?

The court held that the federal benefit is a true annuity "comparable to one which might be subscribed for by any employer for the benefit of an employee and that it follows that if under such circumstances an employee on a cash basis is chargeable with the contribution to the cost of such an annuity made out of his salary, these petitioners [Taylor et al] were required to include the amount of the disputed withholding in their taxable income." This seems to mean that if an industrial employee is required to consider as taxable income "contributions to the cost of such an annuity made out of his salary," then contributions required from Taylor, a federal employee, are immediately taxable. Thus the circle is complete. We sought light in the Taylor case for the treatment of compulsory contributions to industrial plans and find this case resting on the rule we are questioning. However, we go somewhat further because of the importance attached to this case and one on which it rests.

In the Taylor opinion the above quoted sentence leads up to a parallel with an earlier case, as is brought out in the next paragraph of the opinion as follows: "As to this issue, we think there is no longer room for argument. In Renten K. Brodie, 1 T.C. 275, a substantially similar question was disposed of in respondent's favor." In this case the company president had, without consulting his employee, Brodie, determined that the employing company should pay a substantial sum for a deferred annuity contract to belong to Brodie. The fact was brought out that Brodie made application for the contract. The Commissioner of Internal Revenue held the consideration for this contract taxable as compensation to Brodie at the time the contract was issued rather than when benefit might be received. The Tax Court supported the commissioner.

The Brodie case followed closely a similar one from the same industrial organization, Dupree v. Commissioner, 1 T.C. 113, which proved easy to handle because, while the employing company purchased an annuity for Dupree, before doing so it offered to pay him the purchase money in cash. This offer made the purchase money income to Dupree under well established rules of constructive receipt. While Dupree never had the money, he could have had it but preferred to instruct the employer to use it to buy an annuity contract for him. The money was at his command; he chose to authorize purchase of an annuity contract with it. The Dupree opinion centered about the fact of constructive receipt and hence left no room for doubt as to the justice of the decision. This was a clear cut decision, easy to reach and amply supported by precedent.

Brodie, on the other hand, was given no choice and was not even informed until after the event as to the amount that the company president, in his discretion, determined should be applied in the purchase of an annuity contract for Brodie. With this one difference, the parallelism of the Dupree and Brodie cases was striking, especially since they arose from the same industrial organization. Reading the facts now leads one to wonder if the employer had not undertaken to accomplish with Brodie, and two others mentioned in the case, what it had failed to accomplish with Dupree, that is, to credit large sums to chosen individuals in such a way that immediate taxation could be avoided by both the employer and the employee. When the Dupree effort failed and the court based its objection solely on the choice of cash open to Dupree, what more natural than to attempt the same objective—only three employees being involved—by keeping them in the dark as to what was to happen until decisions had been made, and giving them no option whatever to take the value in any other way? Each of these employees received a good salary and a substantial bonus besides whatever might be used to purchase annuity contracts.

The decision in the Brodie case was the same as in the Dupree case but the opinion was very different. It reviews the Dupree opinion and states frankly "we do not think that it can be held that petitioners 'constructively received,' as those terms are generally understood, the cash which the company used in purchasing the annuity contracts." This makes the layman wonder if there is any importance taxwise in Griswold's third question, "when is it income"? and justifies further attention to this matter of constructive receipt.

This concept has been at stake in many cases and has been treated by many authors writing about income taxes. It is discussed at length by Paul and Mertens. These authors quote from Corliss v. Bowers, 281 U. S. 376: "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."[16] This quotation indicates that the item in question in the case is interpreted as income; it does not say that an item must have the characteristics enumerated to be income. Hence the value, for instance, of the Avery case, 292 U. S. 210, in which the Tax Court and the Circuit Court of Appeals for the Seventh District were overruled, the deci-

[16] R. E. Paul and Jacob Mertens, *Law of Federal Income Taxation*, Chicago: Callaghan and Co., 1934, p. 439, footnote 10.

sion being that dividends not available to a shareholder until January were not income constructively received in December, even though dividend checks were prepared in December.

The Paul and Mertens' text continues as follows:

> If the taxpayer is to be deemed in constructive receipt of income, the essential point is that he must have an unqualified right to the use and enjoyment of the money and other property deemed to be income. There must be no strings on the taxpayer's right to receive and to do with the income as he pleases. . . . Employment contracts often contain provisions that what may eventually be income cannot be drawn down for a period of years and only on the happening of certain events. Such items are obviously not presently taxable.[17]

Another statement by Paul and Mertens seems significant in considering the Brodie case: "Good faith is more often than is acknowledged inherent in this type of question, turning the decision one way or another."[18] No hint of bad faith appears in the Brodie opinion but its argument is weak and its statement sustaining the Commissioner of Internal Revenue leans for support on argument presented by the commissioner that is not reproduced in the opinion. The court's opinion emphasizes that the consideration for the annuity had not been "constructively received" by Brodie according to the usual meaning of these words, but continues in part as follows:

> However, while we do not think that the doctrine of constructive receipt as it is commonly understood can be correctly applied in these proceedings, it is undoubtedly true that the amount which the commissioner has included in each petitioner's income was used for his benefit, albeit not at his own direction, in purchase of an annuity contract, and the contract so purchased was issued in the name of the annuitant and was delivered to him and was part of the plan for his additional remuneration. Do these facts result in the receipt of income in the amounts determined by the commissioner? Respondent contends that they do, and he relies principally upon the broad and comprehensive language of Section 22(a), *supra*. In this contention we think the respondent must be sustained.

After sustaining the commissioner, the Brodie opinion proceeds to cite several cases in which large premiums paid for life insurance for a few special employees were held to be income to the employees when paid and adds: "The facts being what they are, we can see no distinction in principle from the issue involved in the instant proceedings and that which was involved in the above cited cases. It seems to us that our decision must be the same."

[17] R. E. Paul and Jacob Mertens, *Law of Federal Income Taxation, op. cit.*, p. 442.
[18] *Ibid.*, p. 444.

This is mentioned here because our interest in the Brodie case rests on its citation by the Tax Court as disposing of "a substantially similar question." It is unfortunate that the court could find no case with facts more nearly parallel. In the Taylor case very modest contributions were deducted regularly from the employee's salary, this employee being treated in this respect like all other employees of a large group covered by a retirement plan to provide modest benefits in a manner free of favoritism. It involved not the least possibility of understanding between employer and employee to pay large elements of irregular compensation in the way that would involve the least tax burden to the employee. The wording of the sustaining sentence in the Brodie opinion quoted on page 38, and the difficulty that the court had in brushing aside the argument of "constructive receipt" which had been its mainstay in the Dupree case, indicate that the Brodie decision might have been quite different had the facts been closer to those of the Taylor case. In other words, the Taylor case is made to rest on a very poor precedent even from the points of comparison already raised.

But, unfortunately for this support, there is an obvious defect that has not been mentioned. The Taylor case centers about the income status of regular, modest, compulsory contributions required of all employees; the Brodie case centers about the income status of irregular, large, employer contributions applicable to a few specially chosen employees. If the Taylor case had centered about employer contributions, the Brodie case might have been a little more nearly applicable. But the remarkable fact is that employer contributions to the Federal Retirement Fund under which the Taylor case arises have never been considered income to the employee at the time the contributions are made. If there is any issue that could be raised relating to the set of facts in the Taylor case, regarding which "there is no longer room for argument" because of the Brodie case, it is that employer contributions to any retirement system should be income to the employee, constructively received at the time the contributions are made. And yet no employer contributions are so considered if made to any retirement plan for public employees or to an industrial plan meeting the requirements of Section 165 of the Internal Revenue Code.

Hence we must conclude that the Brodie case was poorly chosen as a guide in the Taylor case and that the Taylor case is of no direct value to support the present rule that compulsory employee contributions are income to the employee at the time those contributions are made, because of the vicious circle mentioned above. The opinion in so many words bases its conclusion on the facts we have set out. It says that if employee contributions to other pension plans are taxable, then employee contributions to the Federal Retirement Plan should be taxable.

Stripped of all complications, the questions at issue regarding compulsory contributions can be illustrated thus: *X* offers *Y* a job at a nominal wage of $100 a month, with the understanding that *X* will pay *Y* only $97 a month in cash and will provide him with $6 worth of pension credit. *X* makes it clear that he will hire *Y* only on these terms; he does not offer to pay *Y* $100 in cash regardless of whether or not *Y* might be interested in instructing *X* to use $6 a month to provide pension credit. *Y* accepts this offer and may even sign a blank instructing *X* to deduct $3 a month for pension credit but, if he does so, this does not indicate that he could have had the $100 a month in cash.

Now the question is whether *Y*'s taxable income is $103 a month, $100 a month or $97 a month. Granting that the pension credit is arranged because of *Y's* service and may therefore be considered by him as compensation, and that its presumed cost is allowed to *X* as a deduction in calculating his income tax, does this pension credit constitute income to *Y* at the time the pension credit is created? To make the question definite, assume that *Y* receives a written statement having the force of a contract on the part of a life insurance company to pay the appropriate benefit when *Y* reaches age sixty-five; does this constitute income to *Y* at the time the credit is created? There is no question about *Y* receiving the credit nor about its value; assume further that *Y* considers it of value and recognizes that it was arranged because of his service for *X*; is it income? Everyone will agree that it would be constructive income if *Y* could have had payment in cash but chose the pension credit. But this was not the case. He had no choice but to accept a special element of his compensation in the form of pension credit if he took this particular job.

The question is whether a good expectation to receive certain money payments in the future is income now. Thus stripped to its essentials, it is obvious that it makes no difference whether this expectation arises from an element of nominal salary or whether it may be labeled a contribution by the employer. Comparing with the words of the Supreme Court in Corliss v. Bowers, page 37 above, does this pension expectation constitute "income that is subject to a man's unfettered command?" This seems clearly to be the type of provision mentioned by Paul and Mertens above quoted and repeated here for convenience: "Employment contracts often contain provisions that what may eventually be income cannot be drawn down for a period of years and only on the happening of certain events. Such items are obviously not presently taxable." George T. Altman expresses the thought here involved as follows: "Mere payment of income into a trust for your ultimate benefit is not enough to constitute the amount income to you at the time paid into the trust. The amount must have been available to you at that time and paid into the trust on your direction or by your consent."[19]

[19] United States Congress—Joint Committee on Tax Evasion and Avoidance, *Hearings Before . . . , op. cit.*, p. 303.

Mr. Altman cited the Avery case, 292 U. S. 210, in which the Supreme Court held that a dividend which could not be received by the shareholder before January, because of the administrative procedure of the company, was not income for the preceding year, even though it had been declared earlier and the dividend check had been prepared in December. This case seems to furnish a guide for the present question. Sound pension credit is an expectation of cash to be received years hence if and when certain conditions are met; this dividend was an expectation of cash to be received within a day or two after December 31. The declaration of dividend was a matter of common knowledge but the cash itself could not be obtained before the end of the year. The Supreme Court ruled that the payment expected a day or two later was not income on December 31. It should be emphasized that in neither case is value questioned. In neither case can the item be enjoyed at the time its status as income is being questioned. The amount is not subject to the taxpayer's unfettered command; in fact it is not subject to his command at all.

To avoid confusion, it may be well to bring into the open one more possible difficulty. It may be held that the element of taxable income in addition to *Y's* $97 cash is this expectation, or right, or contract to receive a pension in the future; that *Y* has this right and may have evidence of it in the form of a written contract; that it is his to enjoy as soon as created; that his enjoyment of it consists of the satisfaction and peace of mind that it gives him in feeling his future is secure; that this expectation is subject to his unfettered command, even though there is no way in which he can turn it into any cash whatever.

From the standpoint of any ordinary concept of income this seems far-fetched, especially since there is no way in which *Y* can turn this enjoyment into any help toward paying the tax that will be required of him if this expectation is called income. But, comparing with the Avery case, it would seem that the Supreme Court had no such concept of income. The practical certainty that the dividend would be received in a day or two with all the rights that existed to enforce this expectation, and with the dividend payment an actuality long before tax returns were required for the year ending December 31 after the dividend check had been written and mailed but before it could be received, the court held that on December 31 no income was involved. The shareholder could enjoy the prospect of receiving the dividend just as it may be assumed that *Y* might have enjoyed his prospective pension. In the light of such a decision, what possible reason can there be for interpreting as income now an expectation of benefit that may be received many years hence?

The persistence of the idea that employee contributions are taxable income under all circumstances seems bound up with the tenacity with which we hold to the conviction that there is something objective about what is often only nominal wage or salary. This statement is made only in summary, as the distinction between real and nominal salary was discussed on page 34. Whatever good thing an employee may receive because of his employment, he will consider part of his compensation. For clear thinking, it is important that these goods be classified according to their nature rather than as to whether or not they are part of a stated wage or salary. One good may be coverage by a workmen's compensation law; another may be recreational facilities; another may be pension credits, whether supported by a part of what has been stated as the employee's wage, or by something additional furnished by the employer, or by both. The characteristics of this "good" rather than the nominal description of its support should determine how to handle it. Any one of these goods other than cash, for which the employee could have had cash substituted at his request, qualifies as immediate income, because cash as a medium of exchange would have enabled the employee to have "commanded" this element of compensation and to have used it for any purpose he pleased, whether admirable or otherwise.

Good Faith and Tax Avoidance: At the beginning of a year of high tax rates for individual incomes, it is conceivable that an employer might suddenly write a letter to an employee known to be so situated that he would not suffer from failure to receive cash salary, somewhat as follows: "You will receive no cash salary this year; instead you will receive a deferred annuity contract, with no cash value, guaranteeing the annuity beginning at age sixty-five that can be purchased with your stated salary for this year. If you are not agreeable to this proposition, your services will be discontinued now."

If an employee who receives such a note continues in service, it would seem that the tax collector and the courts should treat the consideration for the deferred annuity contract as income constructively received by the employee. All indications are that services were to be rendered as usual at the usual cost to the employer; hence the employer would deduct this cost as an ordinary and necessary expense of doing business. Even with no record of any collusion on the part of the employee, it seems clear that the purpose is to enable the employee to avoid taxation.

But it would be unfortunate if, instead of labeling as such this tax avoidance or evasion, a court should support this action on the part of the commissioner by some circuitous argument that might later be used to require a tax in a thoroughly innocent instance. Modest compulsory contributions to a retirement plan operating broadly over a long period of years—years of high and low tax rates—are quite different from presumably compulsory contributions that are anything but modest, required of a few highly paid employees, not over a long continued period but for a few years of especially high tax rates. The contrast is all the more striking if made with gratuitous employer contributions to a few favored officers of the company. Yet this is just the procedure followed in using the Brodie case as the principal support for the Taylor decision.

It would, of course, be an administrative nuisance to have one tax rule for voluntary and one for compulsory employee contributions. A difficulty also arises as to the facts in particular instances. Sometimes employers make exceptions when presumably compulsory plans are in effect, by failing to insist that some employees contribute and this immediately throws into doubt the classification of all contributions. It will be difficult enough for retired employees to report what their contributions to retirement plans have been, let alone separating those that were contributed voluntarily. But the solution of an administrative problem should keep within constitutional law; if required contributions are not income and a uniform rule is desired, a way to get it is to postpone taxation of both voluntary and involuntary contributions. A suggestion along this line is developed in the following chapter.

Dean Griswold presented a very thoughtful note on this subject in the *Harvard Law Review* in which he takes the broad point of view that it may be unwise "to tax the employee currently on what is actually so remote, though important, a benefit." He points out that from the employee's standpoint a pension is income when he receives it and that his earnings during productive years must for practical purposes be spread over his whole remaining life: "What he receives after his retirement is in reality his income then, for then is when it comes in to him. To tax him on it at the top bracket of the graduated rates of his earning years is an unfair failure to recognize the economic facts." Griswold contends that there is no substantial reason for distinguishing tax-wise between employer and employee contributions and that "in both cases, the employee's current productive capacity is being utilized to make provision for his retirement." Suggesting safeguards to assure that such payments are dedicated to retirement income and cannot be used otherwise, Griswold states firmly his conviction that taxing statutes should be expressly aimed to give employee contributions the same tax treatment as employer contributions.[20] He goes further and suggests inclusion of the self-employed. In part he writes:

> As long as the plan is really a pension plan, the reasons which have already led to the conclusion that the employer's payment in such a case should not be taxable to the employee until the employee actually receives it, should lead to the same conclusion with respect to the similar payments which are withheld from the employee's wages, either under state or federal law or under the terms of the employment contract. To achieve this result, the tax statutes should be expressly amended so as to provide that amounts paid by an employee to provide bona fide pension benefits after

[20] "The Tax Treatment of Employees' Contributions to Pension Plans," *Harvard Law Review*, December, 1943, pp. 248, 249, 250.

his retirement should be deductible from his current income. . . . With such limitations, provision could also be made for the deduction of pension payments made by the self-employed, or by employees whose employers do not provide a pension plan.[21]

Basis for Taxing Annuities

As already stated, annuity payments are taxable income to the extent that they exceed the consideration for the annuity. The "consideration" for an employee annuity is usually the amount paid by the employee. Prior to 1934 the tax-free part of annuity payments came first; no tax was collected until the total of payments exceeded the consideration. Then the "3 per cent rule" was enacted, under which, from the beginning, annuity payments are divided between return of consideration and taxable income, the latter being 3 per cent of the consideration. After the total of the consideration portions of annuity payments exceeds the whole consideration, annuity payments in full become taxable income.

Perhaps this rule was prompted by the fact that a life annuity may consist of only one payment or may continue for many years; for deferred annuities, earnings on the consideration are not taxed explicitly; for all annuities, earnings on reserves that support annuity payments are not taxed as such. Hence, before the 3 per cent rule was established, if the annuitant died early the government failed to tax this earnings income as well as much of the costs paid by the employer. The early rule gave the annuitant who was to die early a preference over the government, even though both might claim that death cheated them. The new rule divided inadequate returns between the annuitant and the government, but it has many faults from the annuitant's standpoint, which have been brought out by two government studies, one by the staff of the Joint Committee on Internal Revenue Taxation, the other by the Division of Tax Research of the Treasury Department.[22]

The House Committee on Ways and Means in May, 1948, adopted tentative tax proposals that included one for a fundamental change in the taxing of annuities. It would do away with the 3 per cent rule and substitute one under which the taxable income part of annuity payments would be spread over the whole period of annuity payments. For life annuities or pensions, the tax-free part each year would be the "consideration" for the annuity or pension divided by the expectation of life of the annuitant at the time payments began; for payments to be made over a fixed period of time,

[21] "The Tax Treatment of Employees' Contributions to Pension Plans," *Harvard Law Review*, December, 1943, p. 250.

[22] United States Senate—Committee on Finance, *The Taxation of Pensions and Annuities, A Report on H. R. 2948*, Washington, 1946, (79th Congress, 2nd Session) 56 pp.; United States Treasury Department—Division of Tax Research, *The Income Tax Treatment of Pensions and Annuities*, Washington, 1947, 49 + 29 pp. (processed).

the consideration would be divided by the number of years of prospective payments when the payments began. In each case the taxable income portion would continue as long as the payments continue.

This suggestion appears to meet with quite general approval. Logically, life annuities seem to be, tax-wise, in a class by themselves; they exist to furnish a level income throughout the remainder of life whether that be long or short. If they must be mortgaged in any way, they maintain their function best if the mortgage is simply a negative element of the same type as the positive initial annuity. This is the thought behind the new suggestion.

It may seem startling that while rules for taxation and tax exemption of contributions to pension plans play a large rôle in pension planning, the taxation of the pensions for which the plans exist enters the discussion to only a minor extent. But the reason is not far to seek. We are not dealing with an effort to obtain complete exclusion of funds from taxable income. Rather it is Griswold's third question—"when is it income"?

There is keen interest in employer contributions to pension funds being deferred as income, because tax rates have been high in recent years. If employer contributions were classed as income to the employee when contributed while the employee's compensation is normal, the tax would be far from small for him. If they were not deductible by the employer in obtaining taxable income, the added cost would in many cases be sufficient, especially during periods of high tax rates, to make the difference between the existence and nonexistence of a pension plan.

But, however poor the taxing device may be with respect to pension payments, interest is much less keen, because the individual pensioner will pay the tax, the pension is usually well in the future, and the much smaller income anticipated by the individual at that time will, he hopes, make taxes far less of a burden because (1) personal exemptions will cover a much larger proportion of income than while employment continues, (2) the remainder, if any, will be taxed in much less burdensome brackets, and (3) everyone hopes for future peace and prosperity that will result in relatively moderate governmental needs for revenue.

III. EFFECTS OF THE LEGISLATION

The preceding chapters furnish a basis of inquiry regarding the effects that the federal income tax laws and rulings may have had on the development of industrial pension plans. The pages that follow will be concerned largely with what these effects have been, to what extent they were planned and to what extent they are desirable. Has the recent large increase in number of industrial pension plans been due primarily to a sudden realization on the part of employers of their responsibilities to their employees or have the taxing rules played a prominent part? If the latter, is this desirable? What was the principal purpose of the 1942 legislation summarized in Chapter II? Was that purpose fulfilled and were the results good? Do the facts to date encourage us to continue the present procedures or do they suggest that fundamental changes would be helpful?

In forming a judgment as to whether certain results are due to the tax rules or to other causes, it must be borne in mind that without doubt many trends are the result of a composite of causes. Conclusions cannot be drawn regarding the rôle that the tax rules are playing or whether they could be modified to improve results. We must be satisfied with opinions. Here we meet squarely the question of incentive taxation: Is it wise for the United States Government to undertake to direct the development of industrial pension plans by using a taxing or a tax exemption lever?

Influence of Federal Tax Legislation

INAUGURATION OF PLANS

The gradual development of industrial pension plans over a long period of years and the sudden acceleration of their growth in recent years of high taxation was traced in Chapter I. The statistics alone indicate that there may be a close connection between these two phenomena. The testimony of those close to the development of pension plans furnishes striking evidence that this is the case.

Adrian W. DeWind, writing in 1944, credited much of the development to special taxes and the emergency price control act as follows:

> It would be ridiculous not to recognize that the developments in this field [pension plans] in the past three years have been "sparked" chiefly by the excess profits tax and high surtax rates on individuals. To a lesser extent impetus to adoption of plans has also been furnished by the wage control provisions in the act of

> October 2, 1942, amending the Emergency Price Control Act of 1942 and the Salary and Wage Stabilization Regulations under it. These have built a strong shelter of exemption for pension plans from the impact of war-time wage controls.[1]

DeWind also gave quotations to support his conviction that aggressive sales efforts of banks, trust companies and life insurance agents had been effective and that their references to the low costs resulting from the peculiar tax situation were only thinly veiled. Even the cost of investigation ceased to be a deterrent to the employer. DeWind quotes from a letter of a bank to a customer as follows:

> You doubtless already have been consulted by some of your clients with regard to establishing pension plans for their employees which can now be accomplished at a nominal cost.
>
> As you know, this has been made possible through the 1942 Internal Revenue Act which permits employers, within prescribed limitations, to deduct the cost in computing their income tax returns.[2]

The same confusion as to the incentive for the creation of many recent pension plans was stated by K. Raymond Clark:

> Undoubtedly, during the last few years many plans were established for the sole purpose of avoiding the full impact of wartime controls on wage and salary increases and taking advantage of the tax deductions allowed under the law, employers realizing that the Government was bearing in some cases as much as 85½ per cent of the cost.[3]

Hugh O'Neill has expressed the same thought as follows:

> The plans created in the past five years represent a large majority of all pension plans in operation. Their establishment was motivated largely by tax considerations, rather than by an understanding of the fundamental advantages obtained by the employer, or by any appreciation of the possibility that employees might pay the pension bill in the form of deferred wages.[4]

Again, from V. E. Henningson, comptroller, Northwestern Mutual Life Insurance Company:

> It seems fairly obvious, therefore, that the privilege of treating the cost of an employees' pension plan as a deductible expense of the business, thereby reducing the taxable net income under the heavy and increasing tax rates, is an important factor in the present widespread interest of corporations in setting up employee pension

[1] New York University, *Proceedings of Third Annual Institute on Federal Taxation . . . November 1944 . . .*, New York: Matthew Bender and Co., 1945, p. 87.

[2] *Ibid.*, p. 88.

[3] K. R. Clark, *Profit Sharing and Pension Plans*, New York: Commerce Clearing House, 1946, p. 40.

[4] Hugh O'Neill, *Modern Pension Plans*, New York: Prentice-Hall, 1947, p. 13.

> plans. It is probable that this keen interest in pension trusts would not otherwise have been created.[5]

The quickened interest of industrial organizations in pension plans seems natural enough when we bear in mind the pertinent forces released during World War II. As already pointed out, these organizations as a group were rather slow to realize that income tax rules with respect to corporations and individuals made pension plans more attractive financially. As early as 1937, insurance salesmen considered the sale of pension trusts an opportunity as great as any that had yet appeared, because employer contributions were free from income taxation. Even when government expenditures on preparations for possible armed conflict started the long continued acceleration of income tax rates, pension counselors, annuity salesmen, trust officers and lawyers found many employers slow to see or to accept the economic and personnel values of retirement plans. Not until excess profits taxes and curbs on employment practices became oppressive at the same time that an employees' market and great pressure for production drove management frantic in its efforts to maintain or expand working forces did corporation officers become more alert to the "virtues" of pension plans.

Income tax rates sufficiently high to give the effect of the government paying the bulk of deductible business expenses were not conducive to economy in any business dealings. This was, of course, one of the unfortunate effects of taking much of the profit incentive out of industry during the war. A business firm need worry little about the payroll or the cost of entertainment or of raw materials so long as it need pay for them only about 15 cents on the dollar. For this very reason, it was necessary to freeze wages in order to prevent cut-throat competition to obtain help. To be consistent, Congress might have prohibited increases in employer contributions toward pension benefits and the inauguration of pension plans without a downward adjustment of cash compensation. But no such action was taken, and employer contributions to a pension plan approved under subsection 165(a) were ruled not to be compensation within the meaning of the salary stabilization laws. Denis B. Maduro commented as follows upon Treasury Decision 5186, which incorporated this ruling:

> The test of violation of those stabilization laws and regulations is whether or not the pension plan meets the requirements of Section 165(a) of the Internal Revenue Code "as of the date the contributions are made" by the corporation. That is the sole test. If the pension plan meets the requirements of Section 165(a), then the corporation's contributions thereto are not considered salary within the meaning of the stabilization laws and regulations.

[5] "Discussion of Pension Trusts for Retirement Programs," *Record of American Institute of Actuaries*, November, 1941, p. 651.

> If the pension plan does not meet the requirements of Section 165(a), then the corporation's contributions thereto are considered salary within the meaning of the stabilization laws and regulations.
>
> The penalties imposed by the stabilization laws and regulations for a violation thereof are so tremendous that no corporation could afford to adopt or maintain a pension plan which does not meet the requirements of Section 165(a).[6]

Freedom from taxation of employer contributions to provide pension benefits was the source of the sudden popularity of pension plans in 1942 and of the anxiety to see that the plans were acceptable to the Internal Revenue Bureau. An employer was seriously limited in the extent to which he could increase salaries and wages, and any increases were, of course, taxed. But any pension credit that the employer might provide for an employee under an approved plan would cost in many cases only about 15 cents per dollar of value to the employee and the whole dollar's worth would be tax-free to the employee until benefit payments began. This was particularly important with respect to the better paid employees whose salary increases would be taxed in fairly high income brackets. Many of the thoughts expressed above are summarized by the National Industrial Conference Board in a 1944 report as follows:

> Adoption of pension plans has been encouraged by Wage and Salary Stabilization controls. If a pension plan qualifies under Section 165(a) of the Internal Revenue Code, employer contributions to such a plan are not considered salary or wage increases. In a time when salaries and wages have been frozen, the employers have looked to the pension plan as an inducement to hold employees against offers of higher pay elsewhere. The pension plan is considered desirable from the higher-income employee's standpoint, because he is not required to pay taxes on the employer's contributions until they are made available to him. . . .
>
> During the last few years there has been a decided trend toward plans restricted to employees earning over $3,000. Because of the Wage and Salary Stabilization regulations, it has been difficult to increase the compensation of higher-paid executives, and in some instances, the retirement program has been adopted for the purpose of inducing these employees to remain with their present employer rather than to seek higher-paid positions in other companies. A pension plan in lieu of an increase in salary is also considered attractive because the company's contributions are not considered as taxable income to the employee until made available to him.[7]

Without doubt, some pension plans that were established during the period of high income taxes would have been initiated had taxes been

[6] D. B. Maduro, "Some Corporate Income Tax Problems of Retirement Pension Plans," *Journal of Commerce* (New York), July 15, 1943.

[7] National Industrial Conference Board, *Trends in Company Pension Plans*, New York, 1944, (Studies in Personnel Policy, No. 61) pp. 5 and 9.

normal. Statistics showing the growth in the number of such plans in the late 1930's indicate this and there is every reason to expect it. Perhaps the adoption of some plans was accelerated by increasing taxes and increasing competition for employees. Perhaps provisions of some plans that would have been established anyway were modified before adoption because of increased tax rates and changing employment problems. For all such it is reasonable to say that the establishment of a pension plan was more valuable and less burdensome than would have been the case in normal times.

Certainly the more stable industrial corporations that have adopted conservative retirement systems as parts of their long-range planning and because of enlightened attitudes toward personnel problems are to be commended for their foresight. But not so, several thousand organizations that introduced schemes hurriedly, with little information about, and little indication of interest in, the fundamental questions that should be carefully considered to make a pension plan most valuable. L. G. Hanmer paid his respects to the latter group in 1944 as follows:

> But now we find 6,000 or 7,000 new plans piled up in Washington for tax approval and on all sides we hear the question, "What is to happen to them when these abnormal times are over?" There are probably 6,000 different answers—one for each plan—depending on the sincerity and objectives of the companies concerned and the type of administrative mechanism employed.
>
> The problem of the superannuated employee cannot be turned on and off like a faucet. Every enduring enterprise has the problem and must face it realistically. Many, if not most of those pending plans are not and never were intended to be a solution of that problem and are mis-termed "pension plans" to achieve ends of dubious social advantage and to accomplish tax credits of questionable merit.
>
> All such should be killed forthwith and certainly before the personnel of those enterprises had been led to believe their security was assured. Similarly, they should be killed before stockholders had been led to believe the problem was solved by such a plan, and an attempt now made to solve it.
>
> Many of the plans now pending are, unfortunately, "fair weather" plans, ill-advised in their structure and too ambitious to weather a storm. Still, there is some hope for those if the motive of the company was to really solve the problem of superannuation for the permanent good of the business. They can now be revised downward to make them stable.
>
> Nine out of ten of those plans—the tax-promoted or the overly ambitious ones—could and should be terminated forthwith and replaced with ones that are designed as a real solution of the problem and which are so constructed as to be practical of finance through bad times as well as good times.[8]

[8] L. G. Hanmer, "The Future of Pension and Benefit Plans," *Journal of Commerce* (New York), May 15, 1944.

PROVISIONS OF NEW PLANS

Participation of Employees: Perhaps the most outstanding change in pension plan provisions that accompanied high income tax rates was the large increase in the proportion of plans under which contributions are limited to the employer, generally called noncontributory plans. Plans that call for employee contributions usually make these a much smaller proportion of the total contributions than formerly.

For many years there has been widespread conviction that it is good policy to have employees share with the employer in contributions for pension benefits. This is not the place to give details on this point; they can be found in a number of books and many articles. Certainly the merits of this method should not be ignored. Yet, during a period when tax rates are high and there is hope that later on they will be lower, the rule freeing employer contributions of taxation but taxing employee contributions creates tremendous pressure to avoid employee contributions.

Length of Qualifying Period: Plans recently inaugurated require longer preliminary service periods prior to coverage than did earlier ones. In fact, for a while about half the new plans required the maximum period allowable, five years. A flat five-year preliminary service period is socially undesirable. It is especially harmful with respect to employees who have attained relatively high ages when initially employed if the pension benefit is proportional to the number of years of covered service, because the older worker needs as many years of credit as possible to attain an adequate retirement benefit.

This tendency toward a longer waiting period is caused partly by reluctance of the Internal Revenue Bureau to count as deductible employer contributions on behalf of short-service employees, on the ground that a large proportion of them will withdraw from service. Thus, rulings of the Internal Revenue Bureau result in discrimination against those who have been in service for short periods, a group heavily weighted with the lower paid employees—the very ones against whom the law explicitly provides there shall be no discrimination.

MODIFICATION OF OLD PLANS

There has been a definite tendency to modify older plans along the lines that would be expected from the changing tendency of the new plans. Some contributory plans have been made noncontributory; some while remaining contributory in form have waived employee contributions for the present and increased employer contributions. Others have stepped up employer contributions without changing employee contributions, thus increasing prospective benefits; some have decreased employee contributions and increased employer contributions by the same amounts or more.

IMPROVED PENSION ACCOUNTING

The tendency to establish pension plans hastily was a natural result of the high income taxes required by World War II, and accounting methods might have been equally hastily devised had it not been that the Internal Revenue Bureau required various records for examination in determining whether or not a particular plan could be approved. The employer had a strong incentive to furnish these data. The result has been much more orderliness in record keeping and estimating of pension liabilities than was previously evidenced by companies that had the less stable pension plans. Perhaps this incentive was unnecessary for the more substantial companies that had already found good accounting practices essential.

Objectives of the Legislation

With this summary of the effect of income tax rules on pension plans before us, we may inquire whether these were the intended results. Congressional reports have claimed that the rules were meant to encourage adoption of retirement plans. Books and articles regarding industrial pension plans often refer to the progressive attitude of Congress and the liberal tax treatment it has accorded employer efforts to recognize social responsibilities with respect to employees. It seems worth while, therefore, to try to determine whether the legislation actually has acted as an incentive. Bearing on this question are the circumstances under which the various rules were adopted and developed, the interpretations that have been given to them, and a comparison of possible incentive features of other types of rulings with some consequences of the present rules.

PURPOSE OF MAKING EMPLOYER CONTRIBUTIONS TAX-FREE

At first thought it might appear entirely reasonable that amounts set aside by an employer to provide a pension benefit for an employee should be considered income to that employee at the time it is set aside. Hence it may seem that to postpone classing such contributions as income until the employee retires is clearly for the purpose of encouraging the provision of retirement benefits.

If the employer offers an employee the choice of receiving a contribution in cash or having the employer set it aside for a future pension, the rules are clear that this is immediate income to the employee. A rule calling such optional payments income if taken in cash but delaying its timing as income until receipt as pension payments if this choice were made, would definitely encourage the payment of pension benefits, but this is not the rule.

Just why should not the employer contribution be taxable income to the employee immediately in all cases? One answer is, as stated earlier, that it is not at the command of the employee; he can do nothing with it; he cannot use it to buy groceries or to pay taxes; he is not sure he will ever receive it; in fact, under most pension plans, no fixed amount is allocated to a particular employee; a sum set aside on behalf of all of a class of employees is to be of value to those in this class who happen to remain in service until pension payments fall due. Hence, as a rule it would be impossible or very difficult to fix upon the part of the employer's contribution that should be called income to a particular employee at the time the contribution is made.

The earlier rulings that employer contributions were deductible as ordinary and necessary expenses seem clearly to have rested on a conviction that these were reasonable business expenses similar in many respects to wages or salaries. There is no evidence that decisions were based on a desire to encourage pension plans. Apparently no heated contests were involved and to have ruled that such contributions were not ordinary and necessary expenses would perhaps have been interpreted as direct hostility to the provision of retirement benefits.

The provision of subsection 23(p) of the 1942 Revenue Act, explicitly exempting employer contributions for the first time, was clearly restrictive as compared with earlier rules and regulations, the restriction showing every evidence of being designed to minimize tax avoidance.

REASONS FOR TAX-FREE PENSION TRUSTS

In Section 165, which frees employee benefit trusts from taxation, the case for liberality of treatment may seem clearer. Here the government postpones taxes on the income from trust investments until trust funds are distributed and the argument is not available that this income is a necessary expense to the employer similar to compensation. But there is good administrative reason for this tax treatment that has nothing to do with liberality.

The government could consider a pension trust as a third party, an artificial person, and tax it on the income from its investments. But, as pointed out above, it is difficult, if not impossible, to isolate the employer contribution with respect to a particular individual. And even if this is possible, note the complications when pension payments are made if trust fund income is taxed earlier. The pensioner should be taxed on the part of each payment that represents employer contributions but should not be taxed on the part that represents interest on the trust fund. Bear in mind also that the part of a particular pensioner's payments that arises from interest depends in a complicated manner upon his age, sex, period of service, period the pension has been paid, and the provisions of the plan with respect to payments upon death and withdrawal from service. With these complications in mind, it seems that Congress did well to postpone taxing income of employee-benefit trust funds, quite regardless of any thought of encouraging deferred compensation plans. It seems far better to ignore pension trusts as taxable entities and answer the question, "whose income?" by saying the earnings on the trust belong to the employees as a group, the equity of each to be determined by actual payments; and to answer the question, "when is it income?" by saying it is income to each when and as payments are received.

EFFECT OF TAXING EMPLOYEE CONTRIBUTIONS

When we turn to employee contributions to pension plans, no evidence of congressional encouragement is found. The one rule already stated and discussed is that such contributions are income to the employee when they are made, even if their payment is required. Although it is easy to see that this rule is administratively desirable, it is not in keeping with the theory of constructive receipt and it thoroughly discouraged the requiring of employee contributions during the recent period of high income tax rates.

PURPOSES OF 1942 LEGISLATION

Was the 1942 legislation for the purpose of encouraging desirable deferred compensation plans? Regardless of the question of public policy, did the framers of this legislation undertake to use the taxing power to direct the development of these plans along lines they considered desirable?

The report on the House bill gave its purpose in these terms:

> In order to insure that stock bonus, pension and profit-sharing plans are operated for the welfare of employees in general, and to prevent the trust device from being used for the benefit of shareholders, officers, or highly paid employees, the amendments require that in order for a trust to qualify under Section 165(a). . . .[9]

A letter from the Secretary of the Treasury to the President dated May 29, 1937, read in part as follows:

> For ten years the revenue acts have sought to encourage pension trusts for aged employees by providing corporations with a special deduction on account of contributions thereto, and exempting the trust itself from tax. Recently this exemption has been twisted into a means of tax avoidance by the creation of pension trusts which include as beneficiaries only small groups of officers and directors who are in the high income brackets. In this fashion, high-salaried officers seek to provide themselves with generous retiring allowances, while at the same time the corporation claims a deduction therefor, in the hope that the fund may accumulate income free from tax.[10]

[9] United States Congress—House Committee on Ways and Means, *Revenue Bill of 1942*, Washington, 1942, (H. R. Report No. 2333, 77th Congress, Second Session) p. 103.

[10] United States Congress—Joint Committee on Tax Evasion and Avoidance, *Hearings Before . . .* , Washington, 1937, (75th Congress, First Session) p. 5.

This report and this letter seem to support a statement made by Senator Robert A. Taft: "The principal purpose of sections 23(p) and 165 was to prevent tax evasion. In drafting the regulations, the Commissioner seems to have been moved more by his ideas of what constituted social welfare than by any consideration relating to taxation."[11]

The House report on the bill and Senator Taft's statement indicate no intent on the part of Congress to cause pension plans to develop along any preconceived lines, but rather an effort to stop some tax leaks that had become serious because of the abnormal tax rates that the war had precipitated.

The 1942 legislation doubtless was belated recognition of an immense administrative problem that was bound to arise with a combination of high tax rates and an effort to control compensation payments. It stemmed partly from a determination to minimize tax avoidance and partly from the related necessity of dealing promptly with an avalanche of new pension and profit-sharing plans. It formalized tax rules that had been used with relatively little controversy when tax rates were low and added important details with the objective of minimizing both controversy and tax avoidance. It was distinctly restrictive legislation. Perhaps it minimized controversy; the degree of its success in checking tax avoidance deserves further consideration.

Senator Taft continues in his *Journal of Commerce* article:

> 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 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.[12]

REALIZATION OF OBJECTIVES

Antidiscrimination Requirements: In order that a pension trust be acceptable for tax exemption, employer contributions must not discriminate against the lower paid employees. One method for assuring this is to require that the plan apply to a specified proportion of the employees, which may be interpreted as a means of making sure that the pension plan is socially commendable. But these same requirements allow omission from considera-

[11] R. A. Taft, "Pension Trusts and Welfare Funds," *Journal of Commerce* (New York), May 29, 1946.

[12] *Ibid.*

tion of as many as 44 per cent of the stable, full-time employees, in addition to part-time employees and those of short service, the latter being measured by a preliminary service period of as much as five years. It is difficult to recognize emphasis on social value in a benefit scheme that omits from participation all part-time employees, all those with less than five years of service, and as many as 44 per cent of all other employees.

As already stated, there has been a tendency to lengthen the qualifying periods for coverage of pension plans to or toward five years of service. This is definitely an undesirable tendency from the standpoint of social value of pension plans. As is explained elsewhere, the preliminary service period has often been practically forced to five years by decisions in individual cases that contributions for earlier service may not be tax-exempt if benefits are forfeitable. This rule is a deliberate makeshift to avoid overfunding and is strong evidence that the purpose of the law and regulations is to collect taxes rather than to act as incentive legislation for the social good. It is directly contrary to the social good.

Deductible Contributions: Subsection 23(p) contains a series of provisions to avoid exempting excessive amounts of employer contributions from taxation. No legal limits are placed on the amount of contributions so long as discrimination is avoided, but great care is taken by statute and regulations to limit the tax-free amount. There is no requirement that contributions shall be sufficient to support the benefits set out in the plan. Certainly this is not conducive to the development of socially desirable pension plans. If there is any one thing that is essential to a pension plan to make it valuable to the prospective pensioner, it is that there be a high prospect that pensions will be paid as planned.

Investments: The only reference in Section 165 to investments of a pension trust is that they shall be exclusively to furnish benefits for employees and their beneficiaries. The law takes no interest whatever in the quality of the investments of the trust so long as they avoid the company's stock and securities.

Lack of Supervision: If we were dealing here with incentive legislation and if the object were to encourage by tax exemptions the development of deferred benefit plans of maximum social value, it would be expected that tax exemption would be permitted only in case (1) the plan were set up soundly, (2) investment restrictions existed to assure safety of a savings bank or life insurance company level, (3) precautions as to administration assured a high quality of service, and (4) some supervisory officer were assigned the duty of examining and requiring reports, the object being to maintain standards in so far as possible and to disclose for correction any weaknesses that might develop.

The absence of any indication of this point of view toward pension trusts or deferred benefit plans more generally indicates that the legislation under review had no such objectives. On the contrary, the indications are that the interests behind the law and the regulations are those of a tax collector trying to prevent tax avoidance, even at the expense of possibly weakening the plans financially.

This is not an argument for incentive taxation. Perhaps it would be unwise to attempt direction of the development of employee benefit plans by levying or refraining from levying income taxes. Even if this were attempted, it would seem unwise to initiate such a scheme during a period of abnormally high tax rates. But if a policy of this kind has not been behind the provisions of Section 165 and subsections 23(a) and 23(p) of the Internal Revenue Code, it might be well to avoid claiming that it is, in statements of legislators calculated to gain popular approval or in statements of employer organizations calculated to curry favor from Congress or federal administrators.

The soundness of thousands of pension trusts today rests on the voluntary precautions of employers and trustees and whatever meager limitations of state law may guide or inhibit trustees. Yet these trusts and the plans of which they are parts purport to have as their sole objective the furnishing of pension incomes after the income producing powers of employees cease. Expected benefits are usually monthly payments to continue until death. If in the not-far-distant future even a few of these plans should fall down on their undertakings with resulting loss on the part of individuals or families with little else to meet living expenses, we can fully expect criticism of a government bureau that has "approved" such plans. To forestall such criticism, it might be good policy for congressmen and Treasury officials to be constantly reminding the general public that they are taking no responsibility for the soundness of these plans and warning at every turn that continual care is important as a safeguard against disappointment.

With minor exceptions involving relatively small benefits, the general rule among the states is that only a life insurance company may undertake risks that involve what are termed life contingencies. No trust agreement can be required to pay more than its funds make possible according to the rules of distribution that have been set up, and when the trustee does this he has fulfilled his responsibility no matter what ill-fortune may have befallen the trust investments. Certainly an employer would be unwise to undertake such responsibilities, even if he could be held to their fulfilment by the law under which he operates. When a life insurance company is authorized to undertake these risks, very substantial state deposits are required of it, other substantial funds in excess of liabilities must be among its assets, it must make periodic reports to a state insurance supervisor and be subject to his inspection, and it must obey a large body of special statutes that have grown up over a century or more for the protection of individuals to whom benefits are promised, these laws often having resulted from sad experiences at times when precautions had not been so well developed.

While no criticism of trustees, corporate or otherwise is implied, it must be recognized that a trustee can do no more than carry out the terms of a trust agreement; his only alternative is to refuse to undertake the trusteeship. The trust agreement may tell how investments are to be made and may determine what they shall be. But even assuming uncanny ability in making investments and the best of good intentions and good fortune, these factors have no bearing whatever on whether or not the beneficiaries to receive payment live longer than they were expected to live when the amounts trusteed to pay benefits were determined. If the number of lives involved is too small to permit the law of averages to apply, or if poor judgment proves to have been exercised in choosing the longevity assumptions, beneficiaries may suffer.

There is much to be desired in the way of precautions to increase the prospect of performance of the thousands of uninsured pension plans that have been established in recent years. The rules and regulations involved in federal tax levies or exemptions are in no way devised to be helpful in this regard.

Continuous Taxing Policy Reflected in Rules

The preceding paragraphs support the view that tax rules affecting pension plans have grown up gradually to meet practical problems as they appeared and that at each stage they reflect an effort to deal with the special problems of pension plans in a manner consistent with tax rules that apply to other situations. No evidence, other than mere declarations, is found that these rules had been devised either to encourage or direct the development of pension plans along lines calculated to make them more valuable socially.

Since 1942 the Internal Revenue Code has been quite detailed with respect to income taxes and tax exemptions that have to do with employee deferred benefit plans, and the regulations to implement these statutory provisions have been far more voluminous. It is, therefore, worth while to try to see the forest rather than the trees and to seek whatever elements of continuity of thought may have run through the application of income taxes in this particular field. This search seems to disclose a few fundamental principles which may be stated as follows:

1. In determining taxable income of a business firm, deduction is expected of the expenses necessary in conducting the business. Reasonable pension payments have from the beginning been considered "necessary" expenses. For a few years there may have been some uncertainty on this score about sums set aside to pay future pensions and some other deferred benefits, but under rulings of 1921 bona fide payments of this sort which the employer had put beyond his control were considered necessary expenses.

2. From the beginning the basis of taxation of an individual has been income constructively received. Pension payments so qualified, but for a few years there was some uncertainty about employer contributions set aside to pay future employee benefits. Since 1921, however, with perhaps sporadic exceptions, the law and regulations have classed reasonable sums properly dedicated by the employer to future employee benefits as income to employees only when and as received by them. There is still confusion on this point with respect to employee contributions, although the Treasury consistently holds them taxable as income constructively received when the contributions are made.

3. Employee trusts, properly set up solely to provide deferred employee benefits, have not been taxable since 1921. This gives a distinct employer advantage to trust funds as compared with reserves held among the employer's assets to pay pensions, in that investment earnings of the latter would be income to the employer for tax purposes.

4. Exemption of a type of income from taxation is not usually involved; double taxation is avoided. Whenever employer contributions are not taxed, the resulting benefit payments are taxable income to the recipients. Employee contributions are not deductible when made but a corresponding amount is intended to be tax-free when benefits are paid. The income from a pension trust is tax-free but becomes taxable to the pensioner.

Briefly summarized, these principles amount to saying that, when bona fides are established, employer contributions and income from their investment are not taxed as income, but the benefits that they provide are taxable income to the recipients when and as received. All other contributions are income to employer or employee at the time they are made and corresponding benefits to pensioners are usually not taxable.

With comparatively minor exceptions, all legislation and regulations since 1921 in this field have been for the purpose of carrying out these fundamental ideas, which have been continuously the basis of taxing policy. There is little evidence that this taxing policy was generally important in the decisions of most employers regarding the provision of retirement income until rates of taxation soared as a result of World War II. Then the detailed amendments of 1942 appeared, followed by lengthy and troublesome regulations, largely to establish bona fides: Are the prospective benefits reasonable? Is the real purpose of the plan to provide these benefits? Is the employer interested in a prospective recipient as an employee or otherwise—for instance as a stockholder or a member of top management? Are the prospective benefits in recognition of service or for other reasons? Does the employer seriously intend to establish a continuing plan or is he merely attempting to avoid taxation?

These points have been keenly contested because large sums of money were involved. The high tax rates furnished intense incentives to avoid payment. On the other hand, to a government sorely in need of abnormally large funds, it is essential that tax collectors should enforce the law. But, despite the government's war needs for revenue, and despite the extraordinary impetus that developed for the establishment of deferred employee benefit plans, the main guides to income taxation that have to do with pensions and their preliminary funding have remained practically unaltered from the beginning.

Effectiveness of Curbs on Tax Avoidance and Discrimination

Assuming then that these tax rules applicable to pension plans were devised primarily as fiscal measures to aid in implementing a consistent taxing policy with little or no intention to favor a particular social philosophy, it may be well to ask how successful they have been.

How have tax collections fared under these rules during recent high tax rate years? Substantial sums have doubtless been collected that would have escaped under the pre-1942 rules, particularly with respect to small numbers of high-salaried employees. Little tax revenue has been received in connection with normal plans covering employees generally; contributions have been largely from employers and have been deductible. Except with respect to highly paid employees, tax revenue from pensioners is small because of the low surtax brackets of the pensioners and the correspondingly high proportion of taxable income that is balanced by personal exemptions. Of course, the sum total of such taxes will run into the millions, but, percentagewise, it is an extremely small element of our income taxes.

Perhaps agreement is general that the loose requirement of subsection 165(a) before 1942 that a deferred benefit plan must be for the "exclusive benefit of some or all" of the employees was due for a change. The words "some or all" were being used to defend plans under which the employer made extravagant contributions for a very few favored employees. We can also sympathize with those who tried to draft correcting amendments, because of the difficulties they encountered. While the 1942 provisions have curbed some of the mose flagrant cases of tax avoidance, the solution is far from perfect. In fact it will be difficult to avoid abuse by relatively small firms in periods of high tax rates and high profits without using a different approach. In such a period a small firm might not hesitate to adopt a plan calling for extravagant contributions for low paid as well as high paid employees if this promised large tax savings.

The solution is defective even for large corporations, especially with the failure of Treasury officials to gain approval for their recommendation that pension equities be vested. As already pointed out, an employer may, under a plan with the usual limited vesting provisions, contribute liberally with respect to the rank and file of low paid employees, with assurance that the eventual pension load will be small and that a large part of the contributions made on their behalf in periods of high taxes and high income will eventually support benefits for supervisors and officers.

As Hugh O'Neill remarks, "Only a small minority of employees live, or remain in the employ of a particular employer, until retirement age."[18] And the glaring fact is that all too small a proportion of workers remain with a particular employer even for a period of ten years—a common requirement for vesting of employer contributions. Thus the 1942 amendments seem only mildly successful in preventing tax avoidance; they fail in their effort to see that plans shall "benefit" officers, supervisors and highly paid employees no more than others. To accomplish this seems practically impossible without fully vested pension equities and short qualifying periods for coverage under a plan.

Major Effects on Pension Plans

As noted in earlier pages, tax rules have improved accounting procedures of pension plans, have decreased the proportion of contributions from employees and have lengthened the period of service required for participation of new employees. Of course these effects have been particularly marked in fairly recent years because of the high income and excess profits tax rates that have prevailed, the full employment status and the curbs that applied during the war on employment practices. More striking than any of these effects, this combination of circumstances was responsible for a wide interest in pension plans and their relatively sudden inauguration in very large numbers.

The introduction of sound accounting procedures is particularly valuable because practices thus established will continue in the future and will safeguard financing by almost automatically calling attention to any unfavorable relations between pension liabilities and assets. To appreciate the degree of this advance it is only necessary to look back thirty or forty years to the lack of understanding as to the cost of pensions and the absence of reserves for their support that then prevailed.

There is no reason to think that those who drafted any of the tax rules had any desire to modify the sources of contributions to pension plans. But these rules make the purchasing power of employer contributions much larger than that of employee contributions during periods of high tax rates, with the result that employee contributions now play a much smaller rôle than formerly. As already stated, the view is generally held that there are definite social advantages in having nearly equal contributions from employer and employees.

[18] Hugh O'Neill, *Modern Pension Plans*, *op. cit.*, p. 16.

It is unfortunate that antidiscrimination rules have tended to lengthen preliminary service periods. No employer can be expected to provide a satisfactory pension for a worker after only a short period of service; hence, especially for those who are employed at fairly advanced ages, it is important that coverage under the pension plan begin as soon as possible.

IV. SUMMARY AND RECOMMENDATIONS

Summary

This study has reviewed briefly the development of (1) industrial pensions in the United States and (2) the federal statutes and interpretative rulings that determine the conditions under which pension payments and contributions for their support constitute income for tax purposes or are deductible from gross income in calculating net income for tax purposes. The objective was to form judgments as to the effect of income taxation on the development of pension plans and as to whether or not these effects are good.

The first chapter traces the development of pension plans in industry. It finds a very gradual growth prior to the last decade, followed by a very rapid recent growth especially beginning about 1942. The second chapter summarizes the tax rules that bear on pension payments and contributions for their support, from the passage of the first continuing income tax law of 1913 up through the detailed amendments of 1942 and discusses these tax rules and their interpretation by administrative bodies, the courts and students of taxation, with particular reference to their bearing on the provisions of pension plans and their administration. Finally, the third chapter takes up the effect of tax rules on the creation of pension plans, on the provisions of new plans and on modifications of plans previously established. It seeks the purpose of the tax rules, the degree of their success and any need for changes.

The evidence found in this study indicates that income taxes had little to do with the development of industrial pensions until about a dozen years ago and that in earlier years revenue officers considered pension plans as somewhat incidental in their application of tax rules. As tax rates increased, especially for corporations and other business firms, more official interest developed.

The general principles of relevant tax rules were established gradually while pension plans were in their infancy and tax rates were modest. With respect to the employer, first pension payments and then contributions for future pensions, when placed beyond his command, were ruled by courts and revenue officers to be deductible in calculating taxable income. At that time employee contributions were rare and practically always were voluntary. They were, therefore, ruled to be nondeductible in calculating the employee's taxable income. When the question of compulsory employee contributions arose—this is unusual with industrial pension plans even today—the rule of nondeduction was well established and has successfully resisted change. Since 1921, earnings of funds separately trusteed to support pensions have been freed from taxation until distribution occurs. Pension payments are taxable income except to the extent that they balance contributions for which the employee has been taxed.

These are the fundamentals of the tax rules. They center about employer contributions being legitimate business expenses. The intention is that income should be of a taxable class sooner or later and that double taxation should be avoided. Much of the legislation of 1942 was to establish bona fides and thus minimize tax avoidance.

SOURCES OF CONTRIBUTIONS

This study concludes, as set out in detail in Chapter II, that one of these fundamentals is wrong. Employee contributions should be deductible in calculating taxable income. Compulsory contributions are not income; while voluntary contributions may be income, a single rule for all employee contributions is desirable. And besides, so long as employee contributions are taxable, the tax rule will have an artificial, undesirable influence on the sources of contributions to pension plans. Direct employee contributions will be avoided, although they are considered socially desirable and it is well understood that in reality all contributions must come from total production.

A way should be found to enable an individual to provide a retirement benefit for himself on the same terms tax-wise as if the contributions came from an employer. There is no justification whatever for the present disadvantageous position, from this standpoint, of the business or professional man who operates an unincorporated means of livelihood.

TAX AVOIDANCE

Much of the 1942 legislation discussed in earlier pages was to prevent tax avoidance. The evidence indicates that it has been only mildly successful. When emergencies arise that call for immense increases in federal revenues, organizations should not find it easy to avoid their part of the responsibility by hiding behind a claim that they have become public benefactors through employee benefit schemes they have suddenly adopted. Nor should they find it easy to use the mechanisms that have been approved for widespread employee benefits to feather the nests of a few executives who are already so favorably situated that, under the emergency legislation, they would be expected to make unusually large contributions to the public treasury.

During a national emergency there is no justification for allowing the accumulation of pension credits more rapidly than would be normal if there were no emergency. Whenever wage stabilization is justified by the conditions of an emergency, firm restrictions are appropriate on the inauguration or expansion of pension plans unless it can be shown that corresponding downward adjustments are being made in cash compensation. Under such circumstances the profits of many firms are larger than normal; the very existence of an excess profits tax indicates this. A novel use of abnormal earnings is not then justified merely because it is admirable, especially if these unusual earnings can be traced to the same causes that gave rise to the excessive national revenue needs.

REQUIREMENTS FOR SOUNDNESS

The taxing power might well be used to safeguard pension plans financially without undertaking to influence them otherwise. If the federal government is to put its stamp of approval on a pension plan, it would seem to be in the public interest that precautions be required as to (1) the financial soundness of the undertaking, and (2) the continuing ability of the fund to meet the expectations of prospective beneficiaries. These precautions are particularly important in view of the fact that many of the pension plans that are funded through separate trust agreements have far smaller coverage than state laws require of life insurance companies for the protection of policyholders.

RECOMMENDATIONS

To be more concrete regarding a number of suggestions in the above summary, tentative recommendations are added:

1. Allow an employee, with proper safeguards as to bona fides, to deduct contributions to a pension plan in calculating net income for tax purposes,
2. Permit regular contributions of an individual to purchase long-term annuity payments or their equivalent for himself or another to be deductible in obtaining net income for tax purposes, if corresponding safeguards are provided,
3. Enact additional safeguards to prevent (a) tax avoidance by employers in connection with contributions to pension plans, and (b) the installation or expansion of pension plans without corresponding changes in compensation whenever federal restrictions on wages and salaries are in force,
4. Vest employer contributions to provide retirement benefits in particular employees in full from the time they come under the plan or by rapidly increasing fractions leading to full vesting after say five years of coverage,
5. Grant the Internal Revenue Bureau approval of a pension plan only if it meets the requirements of a state insurance department or a similar

state or federal office which sets up requirements similar to those for life insurance companies,

6. Replace the 3 per cent rule as applied in determining taxable income for pensioners by the suggestion from the Treasury Department for spreading the deduction of "consideration" over the whole period of pension payments,

In connection with the first three recommendations, it is recognized that much depends on the safeguards mentioned. To go into detail here as to what these should be would involve a major study, but a few suggestions will be set down. With reference to deductible contributions, whether from employer or employee, one requirement might be regularity. Neither employer nor employee should be permitted freedom from taxes on unlimited amounts in some years and on little or nothing in others; such variations alone indicate that tax avoidance is involved. Also, an upper limit on deductible contributions seems appropriate; this ought to be a liberal figure for provision of a modest retirement benefit by means of contributions over a substantial period of years. Perhaps the total of allowable contributions with respect to an individual, regardless of source, might be 15 per cent of compensation or earnings in any one year or, better, 15 per cent of the average for several years.

The second recommendation would doubtless need much refinement to be practicable but it would seem worthy of attention. The present tax advantage of an employee, as contrasted with an individual operator, with respect to provision of retirement income is indefensible and it would be all the more so if employee contributions should become taxable only when distributed under provisions of the pension plan.

Recommendation 3(a) is prompted by the fact that at present an employer who is interested in sharing the gains with a few highly paid officers can meet all requirements for integration and other safeguards against discrimination and still indulge in tax avoidance. This may be tax avoidance for the employing firm or for the highly paid employees or both. Perhaps limits on contributions either in dollars or fractions of compensation would help. If many rank-and-file employees are involved, a requirement of vesting would be effective.

Quite aside from the value of vesting provisions in assuring pensions for a large proportion of employees—and there is little such value unless pension equities are noncashable—it would seem difficult to prevent tax avoidance without it. So long as the employer may discharge an employee without a vested pension equity, the pension plan may provide liberal employer contributions with respect to all employees and still be operated to favor whatever inner circle may be chosen. It is only necessary to see that the period of employment of those outside the favored circle is not too long. There is little prospect that such tactics will be used by long-established reputable firms, but these are not usually the ones notorious for tax avoidance. Furthermore, as emphasized in earlier pages, quite normal employment operations are bound to favor officers and supervisors if pension equities are forfeitable for those with a moderately short period of service.

Perhaps the fifth recommendation is too ambitious to be immediately practicable, but there would seem to be no doubt about the need of something along this line. The similarity of the risks here involved to those of a life insurance company is striking, as is also the contrast between the strictness of the requirements governing the operations of life insurance companies and the practical absence of state requirements with respect to pension trusts. It would be good statemanship to give attention to this matter before instead of after the present dearth of restrictions results in substantial loss to pensioners or prospective pensioners.

APPENDIX

REVIEW OF RELEVANT TAX STATUTES

Developments Prior to 1942

The first continuing income tax law was adopted in 1913. Neither it nor any later revenue act has ever stated whether or not an employer may deduct pension payments made to former employees in calculating taxable income. Such payments from the beginning, however, have been considered legitimate business expenses, when genuine, and their deduction is in keeping with the rule for taxing the recipient, now stated in Section 22 of the Internal Revenue Code.

Treasury Decision 2090 of December, 1914, interpreting Section II, B, of the 1913 Revenue Act, stated that "amounts paid for pensions to retired employees or to their families or dependents on account of injury received are proper deductions as ordinary and necessary expenses." The same thought, expressed more explicitly, appeared in Regulations 33 of the revenue acts of 1916 and 1917, paragraph 438, as follows: "Amounts paid for pensions to retired employees, or to their families or others dependent upon them, or on account of injuries received by employees, or lump-sum amounts paid as compensation for injuries, are proper deductions as ordinary and necessary expenses."

Evolution of Subsection 219(f)

Pension plans were first mentioned in a revenue act in 1926, when subsection 219(f) was changed to exempt pension trusts, as well as stock bonus and profit-sharing trusts, from taxation. This means that income earned by such trusts is not subject to taxation. When originally enacted in 1921, the subsection read as follows:

> A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him.

Even though pension trusts were not named in this subsection, they were from 1921 granted the same tax status as stock bonus and profit-sharing trusts. Before that time the income of a pension trust was immediately taxable to the employer, the employee, or the trust as a separate entity.

In the 1928 Revenue Act the subsection was separated as Section 165 and the wording changed so as to subject to distributee taxation "the amount contributed to such fund by the employer and all earnings of such fund." The Revenue Act of 1932 went back to the method of the earlier subsection by taxing the distributee on the excess of his receipts over his contributions.

The only other change of importance in Section 165 prior to 1942 was an amendment in the 1938 act which required that, to be tax-exempt, a trust must be irrevocable. This involved adding the clause, "and if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the trust, for any part of the corpus or income to be used within the taxable year or thereafter, or diverted to, purposes other than for the exclusive benefit of his employees."[1] A major extension of Section 165 in 1942 will be discussed later.

SUBSECTION 23(Q)

The only other addition to the revenue act prior to 1942 that had a bearing on pension plans was subsection 23(q), introduced in 1928 and renumbered 23(p) in 1936. Interest had developed in placing in trust large reserves already accumulated in company treasuries for pensions in recognition of earlier service. The new subsection covered tax exemption of employer contributions in such cases. As enacted in 1928 it read as follows:

> (*q*) *Pension Trusts.*—An employer establishing or maintaining a pension trust to provide for the payment of reasonable pensions to his employees (if such trust is exempt from taxation under Section 165, relating to trusts created for the exclusive benefit of employees) shall be allowed as a deduction (in addition to the contributions to such trust during the taxable year to cover the pension liability accruing during the year, allowed as a deduction under subsection (a) of this section) a reasonable amount transferred or paid into such trust during the taxable year in excess of such contributions, but only if such amount (1) has not theretofore been allowable as a deduction, and (2) is apportioned in equal parts over a period of ten consecutive years beginning with the year in which the transfer or payment is made.

Since this provision remained effective, with only minor change of wording, until the amendment of 1942, it is important to note that

1. It refers only to contributions to a pension trust,
2. It has to do with amounts paid into the trust in excess of contributions "to cover the pension liability accruing during the year," without specifying for what purpose such additional payments might be made,
3. The words "pension liability accruing during the year" are left without further definition,
4. Parenthetically it states as a fact something which did not appear otherwise in any revenue act prior to 1942, namely, that contributions to such a trust to cover the pension liability accruing during the year are "allowable as a deduction under subsection (a) of this section." As a matter of fact, this had been and continued to be the practice until 1942, but sub-

[1] While this requirement that a pension trust be irrevocable came in 1938 and was in fact made effective only as of January 1, 1940, it seems that the original legislation was intended to require an irrevocable trust, judging from a statement in a 1921 report on the bill by the Senate Finance Committee.

section (a) never contained any words to this effect nor did it contain the words pension, pension trust, pension plan, or contribution. Yet this parenthetical clause continued in the subsection without substantial modification from 1928 to 1942,

5. Of any "reasonable amount transferred or paid into such trust during the taxable year, in excess of" the contribution to cover the pension liability accruing during the year, only one-tenth was to be allowed as a deduction each year for ten successive years in calculating net income for tax purposes. A corresponding provision was incorporated in the amendments of 1942 but it limits the amount allowable in any one year to 10 per cent of the cost of the additional pension credits at the time they are included in the plan without regard to the degree that the payment of the year exceeds this amount,

6. This section is positive in stating that the allowance mentioned is available if payment is to an approved pension trust; it does not state that no such allowance will be possible if payment is made otherwise than to an approved pension trust.

It should be kept in mind that subsection 23(q) had to do only with contributions over and above those to cover "currently accruing liabilities." Thus prior to 1942 the only explicit legislative provisions bearing on the taxation of contributions to pension plans in a declarative manner were (1) Section 165 freeing the income of pension trusts from taxation, and (2) subsection 23(p) spreading over a ten-year period the deduction of reasonable contributions for other than currently accruing liabilities. But, since subsection 23(p) stated parenthetically that contributions toward currently accruing liabilities were deductible under subsection 23(a), it is appropriate to review at this point the practice that had grown up in this regard.

TAX STATUS OF EMPLOYER CONTRIBUTIONS TO PENSION FUNDS

While reasonable pension payments have uniformly been declared "necessary expenses" in Treasury decisions and regulations, contributions to pension funds have had a more varied fate. Paragraph 439 of Regulations 33 applying to the revenue acts of 1916 and 1917, stated "No deduction shall be made for contributions to a pension fund the resources of which are held by the corporation, the amount deductible in such cases being the amount actually paid to the employee." It seems significant that this referred to a case in which the pension funds were "held by the corporation" because, following the 1918 Revenue Act, through Office Decision 110, contributions to a separately organized pension fund were allowed as deductions. The reasoning by which this decision was reached is interesting:

> Donations by a corporation to a pension fund for the benefit of its officers and employees, the fund being organized entirely separate and distinct from the corporation, . . . are deemed to be donations to a charitable institution conducted for the benefit of the corporation's employees or their dependents, representing a consideration for a benefit flowing directly to the corporation as an incident of its business, and are allowable deductions from gross income in determining net income subject to tax.

That this decision is given along with a ruling disallowing contributions to religious, charitable or educational corporations or associations, even for Red Cross or other war activities, indicates the importance of the interpretation.

As already pointed out, subsection 23(p) stated parenthetically that employer contributions to an approved pension trust for currently accruing liabilities were deductible under subsection 23(a). The only part of subsection 23(a) that could possibly have applied covered as deductions from gross income in computing net taxable income of a trade or business "all the ordinary and necessary 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;* . . . ."[2] This provision has remained practically unchanged since 1918 when the words here italicized were added. Repeated Treasury and court decisions make unmistakable that employer contributions to be deductible must be classed as ordinary and necessary expenses.

EMPLOYEE CONTRIBUTIONS NOT DEDUCTIBLE

The rule that under no circumstances may an employee deduct his contributions toward a future pension in calculating his income for tax purposes has applied consistently. Apparently it now rests on the provision of Section 22 that any part of pension payments which represents cost to the pensioner shall not be taxable income. Even if participation in a pension plan is required and contributions are deducted from compensation, so that the employee can receive only the stated compensation less his required contributions, income for tax purposes must be based on the stated compensation, part of which he cannot receive in cash.

TAXATION OF ANNUITIES AND THE 3 PER CENT RULE

Section 22 has always been indefinite with respect to taxing annuities, partly because certain terms are not defined. The regulations issued to cover various classes of instalment payments have not been entirely consistent and have created considerable dissatisfaction. For immediate purposes of this discussion it is sufficient to state that under Section 22 the whole of annuity payments is taxable income with the exception of any part that is a return of consideration paid by the annuitant.

Prior to 1934 the whole of each annuity payment was regarded as return of consideration until the total of payments already made came to exceed the consideration. To illustrate, if the consideration for John Doe's life annuity of $1,000 a year was $10,000, his first ten years' annuity payments would not have been taxable income; they were deemed return of the consideration. Beginning with the eleventh year each annuity payment would become taxable income.

In 1934 subsection 22(b)(2) was amended to provide that, from the beginning of annuity payments, a part of each payment equal to 3 per cent of the consideration should be treated as taxable income and the remainder as return of consideration until the sum of such remaining parts equals the

[2] Emphasis in text supplied by author.

amount of the consideration, after which time the whole of each annuity payment would be taxable income. When annuity payments begin to John Doe, $300 a year is taxable income and $700 a year is a return of consideration until the sum of these $700 items reaches $10,000, i.e., for fourteen and two-sevenths years. During the fifteenth year the final $200 of consideration is returned and in that year the remainder of the annuity payment, $800, is taxable income. Beginning with the sixteenth year, the whole of the $1,000 annuity payment is taxable income.

As stated elsewhere in this study, in calculating the tax on an employee's annuity or pension payable under a pension trust, the sum of the employee's contributions to provide the benefit is taken as the consideration, and, if employer contributions are not deductible, these, too, seem to be counted as consideration for the annuity, although for some cases this last point is not cleared up by law. Under current rules, if separate annuity contracts are purchased with employer and employee contributions, the employee's "capital" will be returned much more slowly than if only one contract is involved. If the separate annuity contracts are assumed to be identical, the contrast between the single contract and separate contracts for the John Doe illustration suggested above is shown by the figures in the schedule below:

Annuity Year	Single Contract*		Two Contracts*	
	Taxable Income	Return of Capital	Taxable Income	Return of Capital
1	$ 150	$850	$ 650	$350
2	150	850	650	350
3	150	850	650	350
4	150	850	650	350
5	150	850	650	350
6	250	750	650	350
7	1,000	..	650	350
8	1,000	..	650	350
9	1,000	..	650	350
10	1,000	..	650	350
11	1,000	..	650	350
12	1,000	..	650	350
13	1,000	..	650	350
14	1,000	..	650	350
15	1,000	..	900	100
16	1,000	..	1,000	..
17	1,000	..	1,000	..
18	1,000	..	1,000	..

* Employee pays $5,000; employer pays $5,000; annuity, $1,000 a year, $500 from employer contributions, $500 from employee contributions.

Much objection has been raised to the 3 per cent rule. The Division of Tax Research of the Treasury Department has presented these objections along with suggestions for change in a recent report.[8]

[8] United States Treasury Department—Division of Tax Research, *The Income Tax Treatment of Pensions and Annuities*, Washington, 1947, 49 + 29 pp., (processed).

AMENDMENTS OF 1942

The 1942 amendments of the Revenue Act that are of major importance in planning for industrial pensions are those affecting subsections 22(b)(2)(B) and 23(p) and Section 165. From its initial enactment as subsection 219(f) in 1921, Section 165 has always purported to do nothing more than (1) define the class of trusts that is exempt from federal taxation when provided for in employee benefit plans, and (2) state the rule for taxation of amounts distributed from such trusts. But the importance of this section was increased in 1928 when subsection 23(q) (later renumbered 23(p)) made compliance with Section 165 the test for allowing deductions to an employer in connection with some of his contributions to pension trusts.

SECTION 165

Before 1942 a trust was exempt from taxation under Section 165 if it was part of a deferred benefit plan of an employer "for the exclusive benefit of some or all of his employees." The 1942 version requires that the trust be part of a plan of an employer "for the exclusive benefit of his employees or their beneficiaries." It seems that the addition of the words "or their beneficiaries" merely authorized an interpretation that had been followed before. But the omission of the words "some or all of" was carefully calculated to strengthen the position of the government that the plan must be for the benefit of employees "in general." Consistent with this idea, two subsections were added to prevent discrimination in favor of officers, shareholders, supervisors or highly paid employees. The new provisions forbid favoring these classes of employees with respect to contributions to, or benefits of, a benefit plan and require that the plan shall apply to classes of employees which do not discriminate in favor of the classes mentioned above or must benefit either (1) at least 70 per cent of all employees, or (2) at least 80 per cent of eligible employees if 70 per cent or more are eligible.

At first thought it might seem that there was no need of condition "1" above because condition "2" would be less restrictive. But assume, for instance, that 90 per cent of the employees are eligible; then 80 per cent of this group would be 72 per cent of the total number of employees, which would be more restrictive as an antidiscrimination requirement than the 70 per cent coverage of clause "1"; in fact, "2" is more restrictive than "1" whenever more than 87.5 per cent of the employees are eligible.

Subsection 165(b) as revised in 1942 is more explicit than formerly about the method of taxing distributees of an approved trust fund. Amounts distributed are taxable to the recipient under subsection 22(b)(2) as if they constituted an annuity, the consideration for which was the amount contributed by the employee. An exception is stated anew at this point—that if all a distributee is to get is paid within one taxable year "on account of the employee's separating from the service," it is classed as gain from sale or exchange of a capital asset held for more than six months and, therefore, receives the correspondingly more liberal treatment. The law provides no such treatment for similar settlement under annuity contracts.

Subsection 165(c) in the 1942 Revenue Act states the rule for taxation of the beneficiary of a trust that does not qualify for tax exemption under this section. Employer contributions are to be considered income to the employee at the time they are contributed if the employee's interest is nonforfeitable at the time. The provision is silent about the tax treatment of the beneficiary if his interest is forfeitable but regulations relieve him of taxation at the time contribution is made.

SUBSECTION 23(P)

Subsection 23(p) experienced a veritable revolution in 1942. Up to that time it had only stated the rule for tax exemption in connection with contributions to pension trusts for past service benefits. The Revenue Act of 1942 includes in this section the tax rules for all employer contributions to stock bonus, pension, profit-sharing, and annuity plans and plans for deferring receipt of compensation. As already pointed out, prior to 1942 employer contributions "to cover the pension liability accruing during the year" could be deducted under subsection 23(a) as ordinary and necessary expenses. From 1928 to 1942, this was stated parenthetically in subsection 23(p), which made no positive declaration as to whether or not the deductions for which it provided explicitly were classifiable as ordinary and necessary expenses and therefore deductible under subsection 23(a). But, while the amendment of 1942 removes deduction of all employer contributions from subsection 23(a), in doing so it states that all allowable deductions must be such as would be deductible under this subsection if it were not for the special provision that brings the consideration of their allowance under subsection 23(p). The words that convey this thought are as follows: "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: . . . ." It seems that the words "without regard to this subsection" are intended to have the meaning "if it were not for this subsection." The provision quoted above leads up to a statement of the various requirements for deductibility of employer contributions, most of which were included in the statute for the first time.

Separate subdivisions give the requirements for contributions to pension trusts, annuity plans, stock bonus or profit-sharing trusts, or, finally, to plans that do not qualify under any of these classifications but in which employee rights in employer contributions are nonforfeitable. They are described and discussed below.

Deductibility of Contributions to Pension Trusts: Contributions to a pension trust are to be deductible only if the trust is tax exempt under subsection 165(a), and are subject to the following conditions:

1. Initially, 5 per cent of the compensation of employees "under the trust" is deductible, but this amount will be reduced if found by the Commissioner of Internal Revenue through periodic examinations to be more than reasonably necessary to provide the service credits.

2. Any excess over the 5 per cent that is needed to cover the cost of service credits of all employees under the trust is deductible, distributed as a level amount or a level percentage of compensation over the remaining service years of each employee, this to be determined under regulations prescribed by the commissioner, with the restriction that if more than 50 per cent of the remaining unfunded cost is on behalf of any three individuals, this shall be distributed over at least five taxable years.

Thus, if contributions take the form of level amounts or a level percentage of salary, there is no limitation on the size of deductible contributions if found by the commissioner to be needed to furnish all benefits under a plan, except that contributions applying to any three individuals must be spread over at least five years if the remaining unfunded cost applying to them is more than 50 per cent of the whole.

3. Instead of this level amount or level percentage method of funding all benefits, whether for past or current service, the employer may deduct (1) the "normal cost of the plan" for the taxable year, and (2) 10 per cent of the cost, at the time included in the plan, of "past service or other supplementary pension or annuity credits"—these amounts to be determined under regulations prescribed by the commissioner.

The law leaves the definition of normal cost to the commissioner. His regulations make it the annual cost, under any one of several methods of calculation recognized as satisfactory actuarially, calculated with respect to each individual as if the plan had been in operation at the beginning of his service. All other credits are lumped in the group for which 10 per cent of the cost is deductible in a single year.

These are not limitations on the amounts that may be contributed to a pension trust but rather on the amounts that may be deducted for tax purposes in a particular year. Amounts contributed in excess of these allowable deductions may be deducted in any succeeding years, to the extent that the limits for those years exceed the amounts contributed with respect to those years.

Deductibility of Contributions to Annuity Plans: Prior to 1942, no provision of the Internal Revenue Code referred specifically to the tax status of contributions to annuity plans. The practice was to allow as employer deductions premiums paid for employee annuities to provide benefits for both current and earlier service.

The 1942 amendments apply the same tests to annuity plans as to pension trusts and describe the amount deductible under an annuity plan by reference to the pension trust provisions of subsection 23(p). It may be of importance to note, however, (1) that reference here is to contributions paid "toward the purchase of retirement annuities" while the words "retirement annuities" have not attained a very clear-cut technical meaning, and (2) that there is the added condition requiring any refunds of premiums to be "applied within the current taxable year or next succeeding taxable year toward the purchase of such retirement annuities."

Deductibility of Contributions to Stock Bonus or Profit-Sharing Trusts: The only limitation placed on contributions to such trusts, after Section 165 is satisfied for purposes of deductibility, is that the total shall not exceed 15 per cent of the compensation otherwise paid or accrued during the taxable year to all employees under the plan. The only definition of either type of plan in subsection 23(p)(1)(C) is expressed in the negative, namely, that the designation "stock bonus or profit-sharing trusts" shall not apply if "amounts to be contributed by the employer can be determined actuarially."

Other Provisions: There are additional provisions in the amended subsection 23(p), the details of which are not essential here. One, already mentioned, covers the taxation of employees with nonforfeitable rights under a plan that does not qualify under any of the preceding paragraphs; another places limitations on employer deductions for contributions to a combination of plans of different kinds, and a final unnumbered, unlabeled sentence in subsection 23(p)(1) states that if a method of employer contributions exists without a "plan" and has the same effect as if a plan existed, it is to be so treated for tax purposes.

SECTION 22

This section defines gross income and itemizes exceptions. Among the 1942 amendments was the addition of a new subsection, 22(b)(2)(B), headed "Employees Annuities." The gist of this subsection is that

1. Taxation of employees whose annuity contracts are purchased by an employer under an approved plan or by a nonprofit employer exempt from taxation under Section 101(6) is governed as follows:

a. If the employee did not contribute, the annuity benefit is taxable as received,

b. If the employee contributed, an amount equal to the sum of his contributions is not taxable when the annuity is received, subject to the "3 per cent rule."

2. Taxation of employees whose annuity contracts do not arise as above is governed as follows:

a. If employee rights under the contract are nonforfeitable, employer contributions are income to the employee at the time the contributions are made and are deductible as consideration when annuity benefits are paid; subsection 23(p)(1)(D) allows contributions as deductions for the employer,

b. If employee rights under the contract are forfeitable, the law is silent. But since subsection 23(p) deals with employer deductions, failure to cover the point would indicate that in this case there would be no employer deductions, which would be consistent with the spirit of the whole scheme of deductions. With the employer being taxed on such contributions, doubtless the employee would be freed at the time the contributions were made. The law is silent as to his status when annuity benefits are paid.

The new subsection 22(b)(2)(B) merely states, explicitly, rules for employee annuity taxation that had applied before. Briefly, annuity payments are income to the annuitant when and as received, with the exception of any part of the consideration for the annuity that may have been taxable income for this individual at an earlier date or dates. This statement assumes taxation of annuity payments in case of a forfeitable benefit under a nonapproved plan. The 3 per cent rule was unchanged by the 1942 amendments.

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[1] All these studies except *An Historical Basis for Unemployment Insurance,* which was published by the University of Minnesota Press, may be purchased from Industrial Relations Counselors, Inc., including the book by Mr. Hicks, who was for some years before his death in 1944 chairman of the board of this organization.

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